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Recommended tax law changes : recommendations for amendments to the Internal revenue code

American Institute of Certified Public Accountants. Federal Taxation Division

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Recommended Tax Law Changes

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Recommendations for Amendments to the Internal Revenue Code

Federal Tax Division

American Institute of Certified Public Accountants

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

1974-75

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FOREWORD

The public interest in tax reform has probably never been greater than it is now. The federal tax division of the American Institute of Certified Public Accountants supports the current congressional review of many basic concepts underlying our self-assessment tax system and is hopeful that greater equity and simplification of our system will result.

The tax division has become increasingly concerned with the impact of our tax system on capital formation and recovery. Even before the recent period of high inflation, our capital needs were accelerating at a rate considerably beyond the ability of our economy to generate new capital. As further consideration is given to tax reform, we strongly urge that Congress give adequate recognition to the impact of taxes on the formation of capital and the recovery of capital costs.

The tax division is presently studying the effects of inflation on our federal tax system. Part of that study is directed toward identifying Internal Revenue Code provisions that contain specific dollar limitations; a preliminary survey indicates there are approximately one hundred such provisions. Many of these limitations were enacted a number of years ago, when our rate of inflation was negligible. That situation has changed in the last two years. Accordingly, we recommend that all Code sections that contain dollar amounts be reviewed periodically by Congress to ensure that the original objectives of these sections are being met.

The tax division intends to continue to submit its views on tax reform proposals as such proposals are developed by Congress, the Treasury Department, and the Internal Revenue Service. As part of this continuing effort, the legislative recommendations in this booklet are offered for consideration. We urge their adoption.

Federal Tax Division
American Institute of Certified Public Accountants

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Determination of Tax Liability

SECTION 1

Treatment of Certain Married Nonresident Aliens and U.S. Citizens as Single Taxpayers

Married nonresident aliens and U.S. citizens or resident aliens married to nonresident aliens should be entitled to all benefits accorded single taxpayers, since they cannot elect to file a joint return with spouse. [Sections 1, 58(a), 217(b)(3), 1201(d)(3), 1211(b)(2), 1348(c)]

The Tax Reform Act of 1969 amended Section 1 of the Code by providing a new lower rate schedule for single taxpayers. The older, higher rate schedule remained applicable to married individuals filing separate returns. This higher rate schedule was retained to prevent married couples, *who could elect* to file separate or joint returns, from arranging their affairs and income in such a way that their combined tax would be less by using separate returns than by using a joint return. Such an arrangement is notably possible in community property states.

Not all married taxpayers, however, can elect to file joint returns. A married person who is a nonresident alien at any time during a taxable year and a U.S. citizen or a resident alien married to a spouse who was a nonresident alien at some time during the taxable year are not permitted, under Section 6013(a), to file joint returns. Nevertheless, the language of the Code requires that these individuals use the higher rates applicable to married individuals filing separately.

This result not only seems contrary to the intent of Congress in adjusting the tax rate schedules, but is inequitable. If married nonresident aliens are required to use the older higher rate schedules, their tax burden will generally be higher than nonmarried nonresident aliens. It would appear that Congress did not intend to discriminate between nonresident aliens who are married and those who are not, and between U.S. citizens who have alien spouses and those who do not.

The IRS has now confirmed, in Revenue Ruling 72-413 (IRB 1972-35, 12) that married nonresident aliens must use the higher separate rates for married persons, although no mention is made in the technical information release with respect to U.S. citizens or resident aliens with nonresident alien spouses.

Similar inequities exist in not allowing nonresident aliens and U.S. citizens or resident aliens married to nonresident aliens to be treated as nonmarried individuals for purposes of

1. the $30,000 exemption in computing the minimum tax for tax preferences [Section 58(a)],
2. the $1,000 and $2,500 limitations on certain moving expenses [Section 217(b)(3)],

3. the $50,000 limit on Section 1201(d) gain in computing the alternative tax [Section 1201(d)(3)],
4. the $1,000 limitation on net capital losses [Section 1211(b)(2)],
5. the 50 percent maximum tax rate on earned income [Section 1348(c)].

The six Code sections listed above should be appropriately amended to allow such taxpayers to be treated as unmarried for the purposes contained therein.

SECTION 47

Disposition of Section 38 Property—Additional Exceptions

Section 47(b) should be amended to provide an additional exception to the definition of "early dispositions" where the sale or exchange of qualifying Section 38 property by one member of a "controlled group" (as defined in Section 1563) is to another member of such group and the transferee agrees to be liable for the recapture of the investment credit upon a subsequent disposition of such qualifying property.

Section 47(b) presently recognizes that an "early disposition" does not occur by reason of a mere change in the form of doing business. However, in order to come within this exception, several requirements are necessary, including (1) the retention by the taxpayer of a substantial interest in the trade or business and (2) a carryover basis to the transferee.

In the situation covered, the property has been sold or exchanged to a different corporation, but the controlled group of corporations has remained intact.

Regulations Section 1.47-4(b) provides for an agreement similar to that contemplated above in order to avoid recapture of investment credit where a corporation makes an election under Section 1372 to be an electing small business corporation.

SECTION 48

Used Section 38 Property

Investment credit should normally be allowed to a purchaser in a transaction if the seller sustained an investment credit recapture as a result of disposing of the property in that transaction. [Section 48(c)(1)]

Under existing law, it is not infrequent for one party to a transaction to suffer a recapture of investment credit without the other party to the transaction being allowed any investment credit. The used property limitations were designed to prevent obtaining an investment credit in each of a succession of transactions involving related parties, but were apparently not intended to result in a complete or partial denial of investment credit (subject to the used property dollar limitations) solely because of such transactions.

The recommendation contemplates allowance to a buyer of investment credit in all such transactions, in the maximum amount of the investment credit recaptured by the seller, subject to the used property dollar limitations as to utilization.

Computation of Taxable Income

SECTION 61

Compensation for Services

Such items as commissions earned by an insurance agent on policies on his own life and real estate commissions received by a salesman on a purchase of real estate for his own account represent a reduction in cost and should not be treated as compensation for services rendered. [Section 61(a)(1)]

In *Sol Minzer* v. *Commissioner,* CA-5, 279 F2d 338 (1960), it was held that a broker's commission on policies on his own life was income to him and in *Kenneth W. Daehler* v. *Commissioner,* CA-5, 281 F2d 823 (1960), it was held that the commission received by a salesman on real estate purchased for his own account was compensation for services.

No economic income can be derived from services rendered to one's self and, therefore, no taxable income should arise.

SECTION 62

Alimony

Alimony payments should be an item to be subtracted from gross income in arriving at adjusted gross income rather than an itemized deduction.

At present, alimony paid by an ex-husband is subtracted from adjusted gross income rather than from gross income in computing taxable income. The ex-wife receiving alimony is required by Section 71 to include that amount in computing her gross income. However, if the ex-husband utilizes the standard deduction, any alimony payments will not be deductible by him; he will receive no tax benefit from the alimony payment. In Michigan, where the state income tax is computed on the basis of the federal adjusted gross income, that amount is reduced by a deduction for any alimony payments. This reaches a more equitable result.

Alimony is includable in the ex-wife's gross income because it is for her use and support, not her ex-husband's. The present scheme discriminates against lower income ex-husbands who use the standard deduction. Consequently, the alimony payments are subjected to double taxation. This is in contrast to the ex-husband who itemizes his deductions. However, even a taxpayer who chooses to itemize, primarily to utilize a substantial alimony deduction, also suffers because he must forego the benefits of the standard deduction.

Therefore, the categorization of alimony as an itemized deduction in Section 215 should be eliminated, and Section 62 should be amended to include alimony payments as a deduction in computing adjusted gross income.

SECTION 62

Adjusted Gross Income

All unreimbursed employee business expenses, such as entertainment expenses, should be deductible in arriving at adjusted gross income. [Section 62(1)]

Under current law certain unreimbursed employee business expenses are deductible only as an itemized deduction and are not treated as a trade or business expense deductible in arriving at adjusted gross income. Section 62(1) should be amended to include all trade or business expenses.

Currently, self-employed individuals may deduct all trade and business expenses in arriving at adjusted gross income, whereas an employee may not be able to deduct the same expense unless he itemizes his deductions.

SECTION 121

Gain on Sale of Personal Residence by Taxpayers Over 65

The limitation under Section 121(b) should be increased from $20,000 to $40,000 to reflect current real estate values.

Since this provision became a part of the tax law, real estate values in general have skyrocketed and the $20,000 limitation no longer reflects realistic values. Therefore, we recommend that the limitation under Section 121(b) should be increased from $20,000 to $40,000 to reflect current real estate values.

SECTION 162

Application of "Overnight Rule" for Business Expenses

A deduction should be allowed for meal expenses on business trips whether or not the taxpayer is away from home overnight. [Section 162(a)(2)]

Section 162 permits a deduction for business expenses while away from home on business trips. The IRS has consistently disallowed such expenses unless the taxpayer is away from home overnight, except where business needs require that rest be obtained during released time.

Until 1967, the courts did not support the IRS, stating, in effect, that the word "overnight" does not appear in the Code and, therefore, has no application. However, in 1967 the Supreme Court of the United States (in *U. S.* v. *Correll et ux.,* 389 US 299 (1967)) held that daily trips not requiring rest or sleep are "not away from home." Thus, business expenses incurred during such trips are not deductible. This decision disregards the basic economic fact that an abnormal expense is incurred in many such situations. The problem is illustrated by the recent case of *Frederick J. Barry,* CA-1, 435 F2d 1290 (1970) in which the taxpayer found it necessary to keep a blanket and pillow in his car for catnaps, but still was not allowed a deduction for meals.

Legislation should be enacted so that the taxpayer is required neither to be away from home overnight nor to rest or sleep to claim this deduction.

SECTION 167

Depreciation of Leasehold Improvements

Leasehold improvements should be considered depreciable property even though the estimated economic life of the property is longer than the term of the lease.

Under the provisions of Section 167, taxpayers are permitted various accelerated methods of depreciation providing the asset is property used in the trade or business of the taxpayer or property held for the production of income. On the other hand, amortization deductions under Section 162 are only allowable in equal annual amounts over the life of the lease.

Regulations Section 1.167(a)-4 indicates that capital expenditures for improvements on leased property are recoverable through allowances for either depreciation or amortization. If the useful life of the improvements is equal to or shorter than the remaining period of the lease, the allowances take the form of depreciation under Section 167. Where the useful life of the improvements is longer than the term of the lease, Regulations Section 1.162-11(b)(1) provides that an annual amortization deduction is allowed which is equal to the total cost of the improvements divided by the number of years remaining in the term of the lease.

The Supreme Court has held in *Hertz Corporation,* 364 US 122 (1960), and *Massey Motors, Inc.,* 364 US 92 (1960), that for purposes of depreciation "useful life" is the period over which the assets may reasonably be expected to be useful to the taxpayer in *his* trade or business, and not the period of the economic life of the assets. If a taxpayer has made improvements on leased property where the term of the lease is shorter than the economic life of the improvements, the useful life to that taxpayer is the term of the lease. This taxpayer should therefore be entitled to an accelerated depreciation deduction and not be restricted to straight-line amortization. In determining the term of the lease, Section 178 would, of course, be applicable.

SECTION 167

Amortization of Intangible Assets

The cost of purchase goodwill, trademarks, trade names, secret processes, formulas, licenses, and other similar intangible assets should be amortizable over a stated period fixed by statute to the extent that such items are not otherwise deductible under other sections of the Code. [Sections 167, 177, 248]

The Code permits a deduction for *development* of certain intangible assets (research and experimental expenses under Section 174; trademark or trade name expenses under Section 177).

It is inequitable to treat the costs of intangible assets *purchased* by a taxpayer differently from those incurred in the development of intangible assets. A taxpayer who purchases certain intangible assets can amortize their costs if a definitely determinable life can be established for them or, failing that, upon proof of abandonment of the asset.

While it may be difficult or impossible to demonstrate with reasonable certainty either a definitely determinable life or abandonment, the value of any intangible ultimately disappears. The recorded cost of such assets should be amortized over some period—if not the useful life, then an arbitrary time period.

A statutory provision for the amortization of the cost of intangibles would recognize the resolution of the accounting problems presented by such assets. The earlier accounting treatment of intangibles without a limited life was to defer their write-off until it became reasonably evident they were worthless. Opinion No. 17 of the Accounting Principles Board of the American Institute of Certified Public Accountants (August 1970) states that the cost of an intangible asset should be written off over its estimated life and that such life should be determined by analysis of appropriate factors, but the period of amortization should not be in excess of forty years.

A similar rule should be established for tax purposes. In addition, there should be provision for recapture of claimed amortization in event of a sale or other disposition of the intangible asset.

SECTION 172

Eight-Year Carryover of Initial Losses

A carryback-carryover period of eight years should be allowed in the case of corporations which have been in existence less than three taxable years. [Section 172(b)(1)]

It frequently happens that new corporations, particularly small businesses, undergo a substantial period of operating losses at the beginning of their existence and may find that the inability to carry back such losses, coupled with the five-year carryover limitation, results in a period insufficient to permit taxable income to reach a level where initial losses can be fully absorbed.

In order to provide relief to new corporations, it is recommended that a combined carryback and carryover period of eight years be provided. Thus, a loss sustained in the first year should be eligible as a carryover for eight years following the loss year; a loss sustained in the second year should be eligible for a one-year carryback and a seven-year carryover, and so forth. This would provide equality of treatment with existing corporations in that an eight-year period would be available to all.

SECTION 212

Deduction for Preliminary Investigation of Business or Investment Opportunities

Expenses paid or incurred by an individual during a taxable year with respect to expenditures incurred in search of a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

Prior to 1957, the IRS followed I.T. 1505 (I-2 CB 112) in permitting a deduction for expenses incurred in determining whether or not an investment should be made. The ruling held that such an investigation constituted a transaction entered into for profit and that upon abandonment of the enterprise the expenses incurred became a loss deductible in the year of abandonment.

I.T. 1505 was based upon Section 214(a)(5) of the Revenue Act of 1921 and related regulations. This section of the 1921 Act corresponds to Section 165(c)(2) of the Internal Revenue Code of 1954, which allows a deduction by individuals for "losses incurred in any transaction entered into for profit, though not connected with a trade or business. . . ."

Revenue Ruling 57-418 (1957-2 CB 143) revoked I.T. 1505 after reviewing the history of the application of the rule and established a new rule that "a loss sustained during a taxable year with respect to expenditures incurred in search of a prospective business or investment is deductible only where the transaction has actually been entered into and the taxpayer abandons the project."

Expenditures made in connection with a preliminary investigation of business or investment opportunities should be deductible even if a taxpayer abandons the prospective project before entering into a material amount of activity in connection with it. Such preliminary expenditures should be equivalent to those which are admittedly deductible where the taxpayer *has* engaged in material activity. See *Charles T. Parker,* 1 TC 709 (1943), distinguished by the IRS in Revenue Ruling 57-418.

There appears to be no equitable justification for limiting the deduction of investigatory expenses to situations where the prospective business or investment was actually entered into and subsequently abandoned. If a taxpayer makes a good faith investigation of a business prospect which is clearly identifiable and incurs expenditures reasonable and necessary thereto, then ordinary standards of equity and fairness should permit deduction of those expenses. The requirement of material activity in the business before deduction of those expenses is permitted places an arbitrary and unbusinesslike burden on individuals interested in development of new economic opportunities.

SECTION 212

Deductibility of Expenses of Estate Planning

It should be made clear that a deduction is allowable for the ordinary and necessary expenses paid or incurred in connection with estate planning.

The economic complexities of life today are immeasurably increased upon death unless there has been proper planning for this event. For this reason, many individual taxpayers seek advice in the planning of their estate. Some of the benefits from such advice are assurance of the proper transfer of assets, the preservation and conservation of these assets until beneficiaries are mature enough to own and manage them outright, saving of income and estate taxes, and obtaining increased liquidity for the estate.

In many instances, it is possible to demonstrate that the expense incurred for such advice is deductible because it was incurred for the management, conservation, or maintenance of property held for the production of income. Thus in *Bagley,* 8 TC 131 (1947), acq. 1947-1 CB 1, the court allowed a deduction for fees paid for advice and planning with respect to rearrangement and reinvestment of a taxpayer's estate.

A major part of most estate planning advice is the possibility of tax savings. Although the advice given is for future use as opposed to advice in connection with an immediate tax liability, the expense incurred to obtain such advice still should be deductible. Expenses incurred for tax advice should be allowed regardless of whether the advice is for present or future tax liability. Tax planning is accepted as a necessary defense, and the cost of obtaining advice to minimize or defer future tax liabilities should be as deductible as similar costs paid for present taxes.

No estate plan is complete without the drafting of necessary legal instruments such as will or trusts. Since such costs are related to the other estate planning activities (i.e., preservation of property, obtaining of tax advice, etc.), the ordinary and necessary expenses for such advice also should be deductible.

This area is charged with uncertainty today, and it would be preferable to have a clear statutory statement that the ordinary and necessary expenses of obtaining estate planning advice are deductible.

SECTION 245

Certain Dividends Received From Wholly Owned Foreign Subsidiaries

The 100 percent dividends-received deduction should be liberalized by reducing the required percentage of ownership by the domestic corporation from 100 percent to 80 percent and permitting this deduction to U.S. corporations whose foreign subsidiaries have less than all of their gross income effectively connected with a U.S. trade or business. [Section 245(b)]

Section 245(a) provides that, if a foreign corporation is engaged in trade or business in the United States for a thirty-six-month period, and if 50 percent or more of its gross income for such period is effectively connected with the U.S. trade or business, a corporate recipient of dividends paid by the foreign corporation is entitled to the 85 percent dividends-received deduction to the extent the dividend is paid out of earnings and profits attributable to gross income effectively connected with the foreign corporation's U.S. business.

Section 245 (b) provides that, in lieu of the 85 percent deduction of Section 245(a), a 100 percent deduction will be allowed if (1) the foreign corporation is a 100 percent-owned subsidiary and (2) *all* of its gross income for the year out of the earnings and profits of which the dividend is paid was effectively connected with a U.S. trade or business. The 100 percent deduction is only available if a Section 1562 election for the parent was not effective either in the year the earnings arose or in the year the dividend is received.

Section 245(b) is generally comparable to Section 243(b), which allows a 100 percent dividends-received deduction for certain domestic intercorporate dividends. However, Section 243(b) requires only the 80 percent ownership needed for affiliated group status to qualify the dividend for the special deduction, rather than the 100 percent required in Section 245(b).

Further, the requirement that *all* gross income of the foreign corporation be effectively connected with a U.S. business seems extremely harsh. The benefits of the 100 percent dividends-received deduction could be lost entirely in situations where as little as $1 of the gross income of the foreign corporation is not effectively connected with a U.S. business.

It does not appear that there is any logical reason why the rules of Section 245(b) should be more restrictive than those of Section 245(a) as long as conditions comparable to those of Section 243(b) are met. Accordingly, Section 245(b) should be amended to permit a 100 percent deduction in an appropriate case as long as there is 80 percent ownership by the domestic corporation and at least 50 percent of the gross income of the foreign corporation for a thirty-six-month period is effectively connected with a U.S. trade or business. The amount of this deduction would be computed on the same basis as is now provided for the deduction under Section 245(a).

The result of these changes would be that, if the domestic parent could have made a Section 243(b) election with respect to a foreign corporation's dividends if the foreign corporation had been a domestic corporation, it would be permitted the same tax treatment as if such an election had been made, but only to the extent that the dividends are paid out of earnings and profits already subjected to full U.S. tax. In cases where a Section 243(b) election would not be permissible if the subsidiary were domestic, either because of less than 80 percent ownership or the existence of a Section 1562 election, the 85 percent deduction would continue to apply.

SECTION 246

Limitations on Deductions for Dividends Received

The dividends-received deduction should be determined without regard to taxable income. [Section 246(b)]

Section 243(a)(1) allows a deduction to a corporation of an amount equal to 85 percent of the dividends that it receives from domestic corporations, but Section 246(b)(1) limits the 85 percent deduction to 85 percent of taxable income. Section 246(b)(2) provides that the limitation in Section 246(b)(1) does not apply for any taxable year for which there is a net operating loss. The limitations imposed on the dividends-received deduction by Sections 246(b)(1) and (2) cause needless complexity and sometimes provide an illogical result when the existence of an insignificant amount of net operating income causes a substantial curtailment in the dividends-received deduction which would not have occurred if a net operating loss (no matter how small) had existed.

SECTION 248

Deductions for Organizational and Reorganizational Expenditures

Organizational expenditures should be amortizable free of any election, and such treatment should be expanded to cover stock issuance and reorganization expenses (including stock dividends and stock splits), expenses incurred in mergers and acquisitions, costs of obtaining equity capital, registration and stock listing costs, and similar expenses of partnerships.

Section 248(a) provides that organizational expenses may, at the election of the taxpayer, be amortized over a period of not less than sixty months to be selected by the taxpayer. The regulations require that this election be made in the return for the taxable year in which the taxpayer begins business and that all of the expenditures subject to the election be specifically identified.

The election requirement of Section 248(a) constitutes an unnecessary complication of the Code. The deductibility of an item should be determined by the nature of the item rather than by strict compliance with the requirements of an election. Organizational expenses and expenses of a like or similar nature should be deductible over a period of not less than sixty months, free of any election.

In addition, the deduction under Section 248 should be expanded to cover stock issuance and reorganization expenses, including the costs of stock registration and stock listing and the cost of printing certificates, whether for original issue, stock dividends, or stock splits. There should be no statutory distinction between creating the legal entity and its reorganization or recapitalization, however accomplished, nor between the cost of creating the entity and the costs incurred in obtaining the equity capital with which to carry out the entity's purposes, either initially or subsequently.

The scope of Section 248 should be broadened to cover partnerships as well as corporations, since such expenses are incurred by partnerships as well as corporations, and there seems no sound reason for discriminating against them.

Assuming the validity of Revenue Ruling 73-580 (1973-2 CB 86), requiring capitalization of salaries of officers and employees and of other expenses in mergers and acquisitions, it should be made less onerous by allowing amortization of such items under Section 248 to the extent that they would otherwise qualify as organization and reorganization expenses if paid to outsiders.

SECTION 265

Dealers in Tax-Exempt Securities

Dealers in tax-exempt securities should be allowed a deduction for interest expense attributable to securities carried in inventory to the extent such interest exceeds the exempt interest earned on such securities. [Section 265(2)]

A dealer in tax-exempt securities may incur debt in order to carry such securities as part of his inventory. In such case, the interest expense is an ordinary and necessary business expense, and its deductibility should not be limited by rules more appropriate to investment activity. The guidelines issued in Revenue Procedure 72-18 (1972-1 CB 740) and the court decisions cited therein make it clear that legislation is needed to permit the dealer a deduction for his interest expense. Such deduction should be reduced by the interest income earned on the exempt securities held in inventory. This rule would result in a clearer reflection of income in the business of dealing in exempt securities.

SECTION 267

Transactions Between Related Taxpayers

A taxpayer on the accrual basis should be permitted a deduction for unpaid expenses and interest of a taxable year if such amount is paid to a related person within the time prescribed for filing the return for the taxable year (including extensions). [Section 267(a)(2)]

Under present law, a taxpayer is denied forever a deduction if payment is not made, actually or constructively, to a related person within two and one-half months after the close of the taxable year. This is true although the income will be taxable to the recipient at the time it is received. This rule has been especially harsh in practice due to the stringent two-and-one-half-month time limit for the payment. For example, in Revenue Ruling 72-541 (1972-2 CB 645), it was held that when the two-and-one-half-month period ended on a Sunday, payment the following Monday was too late.

The principal purpose of the existing law is to prevent related taxpayers from taking advantage of different methods of accounting so as to obtain a deduction without the related party reporting income. The purpose of the law would be equally served if the payment date were extended to the due date of the accrual basis taxpayer's return, including extensions.

SECTION 269

Acquisitions to Evade or Avoid Federal Income Tax

It should be made clear that Section 269(a)(1) does not apply in the case of an acquisition of control of one corporation by another corporation where both corporations were controlled by the same stockholders immediately before the acquisition.

Section 269 provides for the disallowance of deductions, credits, or other allowances in the case of certain acquisitions where the principal purpose of the acquisition is the evasion or avoidance of federal income tax. The section covers two types of acquisitions:

1. Acquisition of control of a corporation.
2. Acquisition of property of another corporation, the basis of which is determined by reference to the basis of such property in the hands of the transferor corporation.

In the case of the acquisition of property (2 above), there is an exception where the transferor corporation and transferee corporation were controlled by the same shareholders immediately before the acquisition. The exception insures that deductions, credits, or allowances will not be denied due to transfers within a single economic group.

As presently constituted, Subsection 269(a)(1) can operate to deny losses or other deductions sustained within a single economic group. The Congressional Committee Reports under Section 129, Internal Revenue Code of 1939 (predecessor of Section 269), do not indicate that this was intended. To the contrary, the reports cite the abuses of purchasing corporations with current, past, or prospective losses for the purpose of reducing income taxes. In the case of *The Zanesville Investment Co.,* CA-6, 355 F2d 507 (1964), the IRS even challenged the deductibility of losses sustained after affiliation of two corporations which were both owned by one individual prior to affiliation.

Rulings published by the IRS have permitted the utilization of tax benefits through statutory mergers (or equivalent thereof) of controlled corporations, since the mergers constituted acquisitions of assets rather than acquisition of control of corporations. See Revenue Ruling 66-214 (1966-2 CB 98), Revenue Ruling 67-202 (1967-1 CB 73), and Revenue Ruling 70-638 (1970-2 CB 71). There is no reason for a distinction.

Accordingly, it is recommended that Subsection 269(a)(1) be amended to make clear that it does not apply where a corporation acquires control of another corporation and both corporations were controlled by the same stockholders before the acquisition.

SECTION 269

Acquisitions to Evade or Avoid Federal Income Tax

The presumption contained in Section 269(c) should be repealed.

This section provides that an acquisition at a cost substantially less than the total of the adjusted basis of the property acquired and the tax benefits derived therefrom shall be prima facie evidence of the principal purpose of evasion or avoidance of income tax. This statutory presumption is unrealistic in that it relates the price of an acquisition to the transferor's basis when the fair market price, in fact, generally bears no true relationship to such basis. Moreover, because the Commissioner's finding that Section 269 is applicable or constitutes a presumption of correctness in itself, the superimposition of Section 269(c) is superfluous.

Most of the Section 269 cases reaching the courts have by-passed this question. In those cases where it has been considered, it has been perplexing and troublesome and has produced interpretations that have done more to confuse than to clarify.

The Tax Court in *H. F. Ramsey Co. Inc.*, 43 TC 500 (1965), expressed difficulty in discerning the logic of Section 269(c) and has indicated in *Industrial Suppliers, Inc.*, 50 TC 635 (1968), and *Arwood Corp.*, TC Memo 1971-2, that it considers Section 269(c) a procedural device and not a conclusive presumption. However, the Fifth Circuit Court of Appeals in *Scroll, Inc.* v. *Commissioner*, 447 F2d 612 (1971), aff'g TC Memo 1969-154, indicated that it attaches considerably more weight to the test.

Because some cases have questioned the logic of this provision and because the rebuttable presumption it creates already exists, Section 269(c) can be repealed without limiting the scope of the provision.

Corporate Distributions and Adjustments

SECTION 301

Recognition of Gain by Distributor Corporation

All gain recognized by a distributor corporation upon the distribution of property to a corporate distributee should be taken into account in determining the amount of the distribution and the basis of the distributed property. [Sections 301(b)(1)(B), 301(d)(2)(B)]

The present statute specifically refers to those sections of the law that provide for recognition of gain by distributor corporations from such things as the distribution of LIFO inventory, properties subject to indebtedness in excess of basis, appreciated property used to redeem stock, and gains recognized under Sections 1245 and 1250. It is recommended that the language in Sections 301(b)(1)(B) and 301 (d)(2)(B) be changed to take into account all gain recognized by a distributor corporation, regardless of the particular sections that might create authority for such recognition, and that reference to selected sections be eliminated. For example, the distribution of installment obligations to a corporate distributee which creates gain recognized under Section 453(d) (See Revenue Ruling 74-337, IRB 1974-28, 23) or the distribution of notes previously charged off as worthless, such as those in the case of *First State Bank of Stratford,* CA-5, 168 F2d 1004 (1948), would not be covered by Sections 301(b)(1)(B) and 301(d)(2)(B).

SECTION 302

Lost Basis—Redemption of Stock Taxed as Dividend

Basis should not be lost when redemptions of stock are taxed as dividends.

It is recommended that specific statutory provisions be enacted along the following lines:

1. Where the proceeds of stock which is sold or redeemed are taxed as ordinary income, the allocation of basis to other stock held by the

taxpayer, if any, should be required. This approach is suggested in Revenue Ruling 71-563 (1971-2 CB 175).

2. If the taxpayer has been taxed on account of attribution (through family, partnership, estate, corporation, or trust), the basis of his stock should be allocated to the stock that was the basis of the attribution.
3. The taxpayer to whose stock basis is allocable hereunder should be allowed at least one year from the date of final determination (that a redemption is to be treated as a dividend) to file claim for refund if the statute of limitations would otherwise foreclose that right.
4. With respect to Section 302(c)(2)(A), if, during the ten-year period in which the reacquisition rules apply, the taxpayer should acquire an interest in the corporation, provision should be made to prevent the loss of the basis of the stock surrendered in the redemption distribution which is subsequently treated as a dividend.

A taxpayer should not lose tax benefit from the basis of shares surrendered in a redemption transaction that is subsequently treated as a dividend. The statute should clearly state what happens to the basis of stock surrendered in such a transaction and should extend the statute of limitations for filing a refund claim if the taxpayer to whom basis is allocated under the statutory rules would otherwise be deprived of tax benefit. If there is a reacquisition during the ten-year period, the statute of limitations is left open for assessment under present law. Similar protection should be extended for the basis of the stock redeemed.

SECTION 302

Constructive Ownership of Stock

The exception to the family attribution rule in determining a complete termination of interest should be clearly expanded to avoid attribution when the family rule would apply to any point in the chain of ownership. [Section 302(c)(2)]

Section 302(c) permits a distribution in termination of a shareholder's interest as described in Section 302(b)(3) to be treated as a distribution in full payment in exchange for stock, even though the family attribution rule described in Section 318(a)(1) might otherwise prevent complete termination.

The position of the IRS is that the exception to the family rule avoids attribution between the redeeming shareholder and the next link but not between other links in the chain of ownership. In effect, the terminating shareholder must be an individual. See Revenue Ruling 59-233 (1959-2 CB 106), Revenue Ruling 68-388 (1968-2 CB 122), and Revenue Ruling 72-472 (1972-2 CB 202).

Where stock in a corporation is owned by a son and by his father's estate, of which his mother is the sole beneficiary, a complete redemption of the son's stock will terminate his interest. The stock of the estate may be attributed to the wife as beneficiary, but under the family exception, the interest of the wife would not be reattributed to her son.

According to the IRS position, however, redemption of the stock of the estate will not result in complete termination of interest. The IRS considers that the stock of the son may be attributed to his mother for the sole purpose of reattributing the ownership to the estate. This is contrary to the result in a situation in which the mother owned the shares personally and the estate did not. Then, either the son or his mother could qualify for a complete termination of interest under Section 302(c)(2).

The Tax Court has recently taken a view in opposition to the Service in holding that redemption of the stock of an estate will result in a complete termination of interest. See *Lillian M. Crawford,* 59 TC 830 (1973), although the IRS has announced its nonacquiescence in IRB 1974-43, 6.

It is recommended that the exception to the family attribution rule described in Section 302(c) be applied to any point in chain of ownership. The exception will then operate in a more logical and consistent manner.

SECTION 303

Distributions in Redemption of Stock to Pay Death Taxes

The present provisions of Section 303(b)(2)(B), permitting the benefits of Section 303(a) in situations where the decedent's estate includes stock holdings of two or more corporations, seem unduly restrictive. The percentage of ownership as to the stock of each corporation required in order for the 35-50 percent tests to apply should be calculated using constructive ownership rules.

This section of the Code now provides for aggregating the values of stock in two or more corporations if the estate owns more than 75 percent in value of the outstanding stock of each of such corporations. In *Estate of Otis E. Byrd* v. *Commissioner,* CA-5, 388 F2d 223 (1968), it was held that this test applies only to directly owned stock. Thus, it is possible for an estate to own beneficially most of the stock of several corporations and yet not qualify for aggregation of the values, simply because some of the stock might be held by other corporations in the same group. It seems equitable that the constructive ownership rules of Section 318 be applied for determining qualification under Section 303(b)(2)(B). These rules now apply to redemptions under Section 302, and there is no logical reason why they should not also be considered in Section 303 redemptions.

SECTION 304

Acquisitions by Related Corporation Other Than Subsidiary

The present statute seems unclear and possibly conflicting in its wording. It is recommended that in a brother-sister acquisition, even though the constructive ownership rules of Section 318 might indirectly create a parent-subsidiary relationship, the transaction should be governed clearly by Section 304(a)(1) rather than Section 304(a)(2).

Section 304(a)(1) presently sets out rules for acquisitions of stock by related corporations other than subsidiaries. Section 304(a)(2) provides rules for acquisitions by subsidiaries. Under the constructive ownership rules of Section 318, stock of a sister corporation can be attributed indirectly to the brother corporation, or vice versa, thereby creating indirectly a parent-subsidiary relationship. A literal interpretation might then require that this type of acquisition (brother-sister) be construed under the provisions of Section 304(a)(2) rather than 304(a)(1). Since there is some difference in treatment under the sections, the statute should be amended to state clearly that an acquisition in a brother-sister situation be governed solely by Section 304(a)(1), and that only a direct parent-subsidiary relationship be governed by Section 304(a)(2).

Although not conclusive, Revenue Ruling 70-111 (1970-1 CB 185) tends to clarify the area and appears to support the clarification sought.

SECTION 312

Effect on Earnings and Profits of Distributions in Partial Liquidations and Stock Redemptions

Section 312(e) should be amended to provide that a distribution in redemption should first be charged to capital based on the percentage of stock redeemed, and the remainder to earnings and profits.

This recommendation follows the long-standing rule set forth in *William D. P. Jarvis,* 43 BTA 439 (1941), aff'd, CA-4, 123 F2d 742 (1941) to the effect that an allocable part of capital is deemed attributable to each share of outstanding stock. Under the *Jarvis* rule, the percentage of ownership represented by the stock redeemed is applied to the capital account to determine the portion of the distribution chargeable to capital. The remaining amount is to be charged to earnings and profits.

The Commissioner acquiesced to *Jarvis* (GCM 23460, 1942-2 CB 190) but twenty-eight years later revoked that position by issuance of Revenue Ruling 70-531 (1970-2 CB 76) and substituted a diametrically opposite rule. According to the ruling, the charge to earnings and profits is only the amount attributable to the stock redeemed. This method, however, was rejected by the Tax Court in *Herbert Enoch,* 57 TC 781 (1972), in which the court followed the *Jarvis* formula.

This conflict should be resolved through amendment of Section 312(e) to support the *Jarvis* holding. The ruling does not have adequate basis, tends to be a trap for the unwary, and does not arrive at a logical result.

SECTION 331

Installment Method Reporting in Section 337 Liquidations

The installment method of reporting gain should be extended to gain attributable to the receipt of an installment obligation originally received by a corporation in a sale of property under Section 337.

Section 337, which was designed to insure that gain on the sale of corporate property is taxed no more than once, operates in conjunction with the rules under Section 331. The provisions of Section 331 require that property, including installment obligations originally received by the corporation in conjunction with the sale of assets and, in turn, received by shareholders in exchange for stock of the liquidating corporation, be valued at fair market value in determining gain or loss recognized on the liquidation.

The present law does not allow a shareholder receiving an installment obligation upon a complete liquidation to report his gain on the installment method notwithstanding that the obligation was originally received by the liquidating corporation pursuant to a sale of property under Section 337. The only allowance made for the receipt of an installment obligation is consideration given to the terms and maturity date in valuing the obligation. This results in a situation where no gain may be recognized on the corporate level, but a tax will be due on the shareholders level. Substantial taxes may be payable, although liquid assets may not be received. On the other hand, taxes can be deferred by selling the corporate stock on the installment method.

It is recommended that Section 331 be amended to allow a shareholder to report on the installment method that portion of gain on the liquidation of a corporation attributable to receipt of the installment obligation. Satisfaction of the installment reporting rules under Section 453 would have to be met at the time of liquidation. It is anticipated that the recapture of depreciation and investment credit would continue to be taken into account at the corporation level. This recommendation is consistent with the purpose of Section 337 and is more reflective of the economics of a liquidation in which installment obligations are the principal assets distributed to shareholders.

SECTION 332

Satisfaction of Indebtedness of Subsidiary to Parent

The rule now stated in this section regarding the satisfaction of indebtedness of a subsidiary to its parent should be amended to provide nonrecognition of gain or loss to the distributing corporation by virtue of distributions of property and discharge of indebtedness created after adoption of the plan of liquidation. [Section 332(c)(2)]

The present law provides only for nonrecognition of gain or loss to distributions of property in satisfaction of indebtedness existing on the date of adoption of the plan of liquidation. Occasionally, it may be necessary to create similar indebtedness after a plan of liquidation is adopted but before the liquidation is completed. There appears to be no logical reason why the nonrecognition rule should not also apply to distributions of property in satisfaction of this type of indebtedness. This potential problem could be avoided by proper advance tax planning; e.g., a taxpayer could adopt a plan of liquidation just before actual liquidation occurs, or, if this is not possible for some reason, the taxpayer could contribute capital to the subsidiary rather than make a loan to the subsidiary.

Since there appears to be no logical reason why the nonrecognition rule should not apply to indebtedness created after adoption of the plan of liquidation, Section 332(c)(2) should be amended rather than remain a trap for the unwary.

SECTION 333

Time Securities Considered Held in Section 333 Liquidation

The carryover holding period for stock or securities acquired in tax-free exchanges should not be limited only to liquidations which occurred in 1970, but should be made a permanent part of the Code.

Section 917 of the Tax Reform Act of 1969 provides, in general, that for 1970 liquidations only, stock or securities acquired in a Section 351 exchange which had been held by the transferor in any period prior to 1954 are to be considered as pre-1954 property. However, based upon the purpose of Section 333 and the tacking of holding periods permitted under numerous other circumstances in the Code, there do not appear to be any policy reasons to restrict tacking to Section 351 transfers. Limiting applicability to 1970 liquidations should also be eliminated.

SECTION 333

Liquidating Distributions Acquired Before December 31, 1953

The cutoff date with respect to the acquisition of stock or securities distributed by a corporation liquidating under Section 333 should be revised. [Sections 333(e)(2), 333(f)(1)]

In determining the amount of realized gain that is to be recognized by a shareholder in a Section 333 liquidation, present law provides that realized gain may be recognized to the extent that the shareholder receives money or stock or securities acquired by the liquidating corporation after December 31, 1953. Originally, this cutoff date was necessary in order to prevent the investment of cash in stock or securities in anticipation of a liquidation under Section 333. The date is now unrealistic. The statute should be changed to fix a cutoff date five years prior to the date on which the corporation adopts its liquidation plan.

SECTION 334

Basis of Property Received in a Liquidation to Which Section 334(b)(2) Applies

In a Section 334(b)(2) liquidation, at the election of the acquiring corporation, allocation of basis of a subsidiary's assets should be made based on fair market values on the date the "80 percent control test" is met if the liquidation occurs within six months thereafter.

The basis of assets received in a liquidation to which Section 334 (b)(2) applies should be determined, when the liquidation occurs within six months after the date that the "80 percent control test" is met, by allocating the basis of the subsidiary's stock in proportion to the assets' fair market values on the date the "80 percent control test" is met. For all purposes of the Internal Revenue Code, the liquidation would be deemed to have been accomplished on such date.

Under Regulations Section 1.334-1(c)(4), the basis of the stock must be allocated to the assets on the basis of their fair market values on the date the assets are received upon liquidation. Enactment of this recommendation would eliminate this burden. Also, its enactment would eliminate complex basis calculations where disposition is made of the assets in the period between the purchase and liquidation dates, where new assets are acquired in that period, and where there are interim adjustments for liabilities and earnings and profits.

The subsidiary's transactions, gains, and losses for the interim period from the date the "80 percent control test" is met until liquidation within the following six months would be reflected in the parent's return as though the subsidiary were a branch, and the subsidiary would not reflect such transactions in its return. If the date on which the "80 percent control test" is met were a date other than the last day of the subsidiary's taxable year, the subsidiary's final return would include only the period ending on such date. In determining gains or losses, depreciation, and other tax effects with respect to the subsidiary's assets in the parent's return during the short period, the basis of the subsidiary's stock in the hands of the parent would be allocated among, and become the basis of, the subsidiary's assets as of the date the "80 percent control test" was met.

As an alternative to reflecting the subsidiary's transactions in the parent's return for the period between the purchase and liquidation dates, a similar result could be achieved by allocating and assigning the parent's basis for the subsidiary's stock to the subsidiary's assets as of the date the "80 percent control test" is satisfied. This allocated basis would then be used by the subsidiary in determining gains or losses on dispositions of its assets during the period up to liquidation and in computing depreciation for such period. The subsidiary's recomputed basis would then pass to the parent without the adjustments provided in Section 1.334-1(c) of the Income Tax Regulations. The subsidiary's cost for assets purchased by it during the interim, adjusted for depreciation (if any) for the short period, would become the parent's basis for such purchased assets.

SECTION 334

Basis of Property Received in a One-Month Liquidation

Section 334(c), which applies to the allocation of the adjusted basis of stock to property received in a liquidation under Section 333, should be amended to provide for allocation in the following order:

1. **To assets which can be converted into cash in a relatively short period of time in an amount equal to their fair market values;**
2. **To Section 1245 and 1250 assets to the extent such gain is recognized;**
3. **The residue, if any, to other assets (including Section 1245 and 1250 assets) received according to their respective net fair market values.**

The present Section 333 basis rules contained in the Regulations provide for the allocation of the adjusted basis of the shareholders' stock to the property received according to the respective net fair market values of the property. Since the shareholders' basis is generally less than the fair market value of the property received, the present basis rules can cause double taxation.

For example, assume a company with no earnings and profits has two assets, a trade account receivable and a building, with respective fair market values of $40,000 and $60,000. The sole shareholder, with a $55,000 stock basis, reports no gain upon liquidation under Section 333. The receivable will have a basis of $22,000 ($40,000/ $100,000 × $55,000) and the building will have a basis of $33,000 ($60,000/$100,000 × $55,000). Upon collection of the receivable, the $18,000 of proceeds in excess of basis will be taxed as ordinary income despite the fact that the company previously reported the receivable as income. A more realistic result would be obtained if the receivable would receive a basis of $40,000 and the building a basis of $15,000. Income relating to the receivable would then be reported only once.

Similarly, assume the company had appreciated post-1953 stock with a fair market value of $40,000, instead of the receivable. The shareholder would be subject to capital gain to the full extent of the fair market value of $40,000 upon liquidation, but would have a basis of only $38,000 for determining gain upon a subsequent sale of the stock. In other words, another $2,000 gain will be realized when the stock is actually sold for $40,000.

Section 334(c) should be amended to provide that the adjusted stock basis be allocated in the following order:

1. To assets which can be converted into cash in a relatively short period of time in an amount equal to their fair market values;
2. To Section 1245 and 1250 assets to the extent such gain is recognized in proportion to the respective amounts of recaptured gain recognized;
3. The residue, if any, to other assets (including Section 1245 and 1250 assets) received according to their respective net fair market values.

SECTION 334

Basis of Property Received in Liquidation

Uncertainty exists regarding the term "cash and its equivalent" as used in Regulations Section 1.334-1(c)(4). The phrase should be defined by statute in order to simplify the determination of basis to be allocated to assets received in corporate liquidations.

Because of uncertainty resulting from administrative practice and the Regulations under Section 334, Congress should establish statutory meaning for the term "cash and its equivalent" as it is used in allocating basis to assets received in a corporate liquidation. In Revenue Ruling 66-290 (1966-2 CB 112), the IRS applied the term to certificates of deposit and savings and loan association accounts, as well as to cash deposits. The ruling stated, however, that the term does not include accounts receivable, inventories, marketable securities, and other similar current assets. *Boise Cascade Corp.*, CA-9, 429 F2d 426 (1970), held that the phrase "cash and its equivalent" excludes marketable securities, inventories, prepaid supplies, and accounts receivable. The decision was followed by the Tax Court in *Madison Square Garden Corporation,* 58 TC 619 (1972).

These interpretations are unduly restrictive, and statutory rules for taxpayers are desirable. The definition should not be limited to cash; the basic concept that should apply is the liquidity of the particular assets involved and whether or not they can be converted to cash in a short period of time. Certainly, marketable securities meet this test and, in most cases, trade accounts receivable and inventory will be converted into cash in a relatively short time and should be treated similarly.

The failure to provide less restrictive statutory rules will continue to foster unreasonable results as, for example, the recognition of gain or loss upon realization of fully collectible accounts receivable balances existing at the date of liquidation. This is illustrated by the following tabulation, which indicates that the adjusted stock basis exceeds by $10,000 the tax basis of the distributor corporation's assets; that is, a "step-up" of this amount is available.

No gain or loss would be recognized to the distributee corporation upon the full collection of the $15,000 of accounts receivable if such accounts were treated as "cash equivalents" in allocating its adjusted stock basis in the distributor corporation among the assets received in the liquidation.

By not treating the accounts receivable as "cash equivalents" the distributee corporation will recognize gain of $866 upon the full collection of these accounts. Such gain results from the mechanical allocation of a portion of the adjusted stock basis to the accounts in an amount that is less than the face value of the receivables (which, in the example, is assumed to be the fair market value of the receivables). Such potential gain would otherwise be reflected in the tax basis of the "Other Assets" at the liquidation date.

The practical effect of not treating the accounts receivable as "cash equivalents" is to create a double inclusion in income to the extent of the difference between the amount of stock basis allocated to the receivables and their fair market value. Clearly, this result is unreasonable, and could not have been the intent of Congress in enacting the provision.

		Fair Market Value	
	Tax Basis	*Amount*	*Relative FMV of Noncash or Equivalents*
Adjusted basis of stock:	$100,000		
Assets of liquidating corporation:			
Cash	20,000	$ 20,000	—
Accounts receivable (face)	15,000	15,000	17⅔%
Other assets	55,000	70,000	82⅓%
Total	90,000	$105,000	100 %
Step-up in basis permitted	$ 10,000		

Allocation (to noncash and equivalents based on relative FMV of assets received in liquidation):	
Cash	$ 20,000
Accounts receivable	14,134
Other assets	65,866
Total	$100,000

Gain/(Loss) on collection of full amount of receivables:	
Receivables	$ 15,000
Tax basis	14,134
Gain/(Loss)	$ 866

SECTION 337

Collapsible Corporations—Application of Section 337

The nonrecognition provisions of Section 337 should apply to sales made by an otherwise collapsible corporation if any of the relief provisions would prevent the application of the collapsible corporation rules. [Section 337(c)(1)(A)]

At the present time the benefits of Section 337 are denied to a corporation which falls within the general definition of a collapsible corporation of Section 341(b) unless Section 341(e)(4) applies. This is true even though the limitations contained in Section 341(d) may prevent the application of Section 341(a), the operative portion of the section, to any of the shareholders. (See *Leisure Time Enterprises, Inc.*, 56 TC 1180 (1971), and Revenue Ruling 63-125 (1963-2 CB 146).) There is no logical reason for prohibiting Section 337 treatment in any case where Section 341 is inoperative. Section 337(c)(1)(A) should be amended to eliminate this defect and, at the same time, to refer to the special provisions of Section 341(e)(4). The amendment should provide that Section 337 is applicable to a collapsible corporation with immediate ordinary income on liquidation, and, if Section 341 is not applicable because of the limitation of Section 341(d), then Section 337 should apply as if there were no collapsible corporation.

SECTION 337

Involuntary Conversions

Section 337(a) should be amended to provide a sixty-day period after involuntary conversion in order to adopt a plan of liquidation.

An involuntary conversion of property as a result of a fire or condemnation proceeding constitutes a "sale or exchange" that is eligible for nonrecognition treatment under Section 337(a). However, in order to qualify, the corporation must adopt a plan of liquidation on or before the date of such sale or exchange.

In many situations, it is difficult or impossible to take appropriate action to adopt a plan of liquidation before a sale or exchange resulting from an involuntary conversion will be deemed to occur for federal income tax purposes. For example, in some jurisdictions state (or local) condemnation action takes place upon the filing of documents in court without notice to the owner. This action is sufficient to cause the immediate transfer of ownership to the state and treatment of the transaction as a sale for tax purposes on that date. A right of litigation over the amount of the award is not sufficient to change the date of sale. See *L. Clyde Dwight* v. *U.S.*, 225 F. Supp. 933 (DC N.Y., 1963); aff'd CA-2, 328 F2d 973 (1964). Under these circumstances it is impossible for the corporation to adopt a plan of liquidation and qualify for the benefits of Section 337(a).

Similar to this is a case of the destruction of property by fire, whether or not the property is covered by insurance. Because the fire is the single irrevocable event that fixes the contractual obligation of the parties, the date of the fire is considered to be the date of the sale or exchange. See the decision of the U.S. Supreme Court in *Central Tablet Manufacturing Co.* v. *U.S.*, 94 S. Ct. 2516 (1974).

In order to prevent inequitable double taxation in these situations, it is recommended that Section 337(a) be amended to provide a period of sixty days after the date of involuntary conversion within which a plan of liquidation can be adopted to obtain the benefits of Section 337.

SECTION 337

Liquidation of a Subsidiary in Section 337 Transactions

Section 337 should be amended to include the liquidation of a subsidiary within the benefits of Section 337 if both the subsidiary and its parent are liquidated within the twelve-month period required by Section 337(a)(2). [Section 337(c)(2)]

As now worded, Section 337(c)(2)(A) has been interpreted by the IRS to deny the benefits of Section 337 in certain parent-subsidiary situations where the assets of a subsidiary are sold by either the parent or the subsidiary during the twelve-month period required by Section 337(a)(2), and Sections 332 and 334(b)(1) apply to the liquidation.

Under present rules, there are available several indirect ways to avoid this result (for example, liquidate the subsidiary prior to having the parent adopt its plan of liquidation or distribute the stock of the subsidiary to the shareholders of the parent as part of a liquidation and have the shareholders then adopt a plan of complete liquidation meeting Section 337). See Revenue Ruling 69-172 (1969-1 CB 99). This approach, however, stresses form over substance; to meet this problem directly, an amendment to Section 337(c)(2) is necessary.

The amendment should extend nonrecognition treatment under Section 337 to the liquidation of a subsidiary if the subsidiary and its parent are liquidated within the twelve-month period beginning on the first date of adoption of a plan of liquidation by the subsidiary or the parent. This approach has been approved in *Kamis Engineering Co.,* 60 TC 763 (1973). The holding in that case should be codified, cf. *Manilow* v. *U.S.,* 315 F. Supp. 28 (DC Ill., 1970).

SECTION 337

Gain or Loss on Sales or Exchanges in Connection With Certain Liquidations

Section 337 should be amended to provide for nonrecognition of gain or loss upon the sale of property in connection with a partial liquidation if a business has been terminated.

Section 337(a) currently provides that no gain or loss shall be recognized when a corporation sells or exchanges property within a twelve-month period in accordance with a plan of complete liquidation provided that all of the corporation's assets are distributed in complete liquidation.

Section 331 provides that amounts distributed in partial liquidation of a corporation (as defined in Section 346) shall be treated as part or full payment in exchange for the stock. Therefore, it is possible for a corporation to liquidate certain businesses that then can be sold by stockholders without the corporation paying tax on the sale of the business. These provisions would apply notwithstanding the continued existence of the corporation that operates a separate business. However, Regulations Section 1.346-3 points out that, where partial liquidations are followed by the sale of the assets distributed to the stockholders, it will be questioned whether the corporation or the stockholders sold the assets.

Court Holding Company, 324 US 331 (1945), has been used by the Internal Revenue Service to impute gain from sales of distributed assets by shareholders to the distributing corporations. However, *Court Holding Company* had a very unfavorable fact situation. In *Harry H. Hines, Jr.,* 344 F. Supp. 1259 (1973), the Fifth Circuit Court of Appeals did not rely on the *Court Holding Company* case to impute gain to the distributing corporation. This opinion very clearly limited the *Court Holding Company* case to its facts. Therefore, that case should not be a deterrent to amending Section 337.

Accordingly, it is recommended that Section 337 be amended to provide for nonrecognition of gain or loss on the sale of property in connection with a partial liquidation where an active business has been terminated, if the bulk sale rules regarding inventory and the other provisions of Section 337 are met, and if the distribution fits within the requirements of Section 346.

SECTION 351

Securities Received in Exchange Transactions Governed by Subchapter C

The nonrecognition provisions of Section 351 extend to transfers of property to a corporation solely in exchange for stock or "securities" in such corporation. The term "securities," for purposes of Subchapter C, should be defined by statute to include a note, bond, or other evidence of indebtedness with a maturity of five years or more. Section 385 would be amended to conform to this definition of "securities."

One of the problem areas under Subchapter C is to determine the meaning of the term "securities." The nonrecognition provisions of Section 351 extend to transfers of property to a corporation solely in exchange for stock or "securities" in such corporation. The phrase stock or "securities" is also found in other provisions of Subchapter C, such as Sections 312(d), 354, 355, and 361. A statutory definition of "securities" would provide guidance to taxpayers and eliminate unnecessary conflict. The definition should provide that a note, bond, or other evidence of indebtedness with a maturity of five years or more would qualify as a security under Subchapter C. Section 385 would also be amended to recognize the new definition of "securities."

SECTION 357

Treatment of Accounts Payable as Liabilities Upon Incorporation of a Cash-Basis Taxpayer

Section 357(c) should be amended to make it clear that accounts payable of a cash-basis taxpayer are not liabilities within the intent of the section for purposes of determining gain upon incorporation of a business in a Section 351 transaction.

Section 357(c) provides, in part, that in an exchange to which Section 351 applies, if the sum of the liabilities assumed exceeds the adjusted basis of a property transferred, then gain will be recognized to the extent of the excess. In the case of a cash basis taxpayer (that never received tax basis nor deductions for trade accounts payable), a literal interpretation of the section leads to an inequitable result clearly not within the intent of Congress. In many cases substantial income may be realized. See, for example, the following decisions: *David Rosen,* 62 TC 11 (1974); *Peter Raich,* 46 TC 604 (1966); *Wilford E. Thatcher,* 61 TC 28 (1973).

However, in *John P. Bongiovanni,* CA-2, 470 F2d 921 (1973), the Second Circuit reversed the Tax Court. It analyzed the legislative history of the provision and, consistent with its interpretation of Congressional intent in enacting Section 357(c), concluded that such trade accounts payable are not "liabilities" for this purpose, drawing a distinction between tax liabilities and accounting liabilities.

The Second Circuit's analysis and interpretation of the section in *Bongiovanni* seems to arrive at an equitable result. It is therefore recommended that in order to prevent litigation, the wording of the statute should be amended to make it clear that the *Bongiovanni* holding reflects the correct interpretation of the law.

SECTION 362

Basis to the Acquiring Company of Stock Received in a "B" Type Reorganization

The determination of basis of the acquired company's stock in a "B" type reorganization should be simplified in a manner similar to that in a "C" type reorganization. [Section 362(b)]

It is often quite difficult to obtain the basis for the acquired company's stock in a "B" type reorganization, particularly where it is widely held, because the IRS has not permitted alternate procedures such as statistical sampling to be utilized in making this determination. In addition, because the acquiring company assumes the transferor-shareholders' bases in the acquired company's stock, while the transferor-shareholders also retain that basis for the acquiring company's stock, the same gain or loss may be recognized twice. It would be recognized once when the acquired company's shareholders dispose of their stock in the acquiring company and again when the acquiring company disposes of the stock of the acquired company. To overcome these problems, the Code should be amended to provide that where, in a "B" type reorganization, 80 percent or more of the stock of the acquired company is acquired during a twelve-month period, a substituted basis for the stock acquired should be allowed equal to the excess of the basis of the assets in the hands of the company being acquired over its liabilities, just as if there had been a "C" type reorganization. This would make the transaction similar to a "C" type reorganization and should simplify operation of the statute. A provision similar to Section 357(c) would have to be provided for situations where liabilities exceed basis.

SECTION 367

Foreign Corporations

The Secretary of the Treasury or his delegate should be given statutory authority to make a determination, after an exchange, that such exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Section 367 provides that in determining the extent to which gain shall be recognized in the case of any of the exchanges described in Sections 332, 351, 354, 355, 356, or 361 a foreign corporation shall not be considered as a corporation unless, *before* such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Sections 1491 and 1492, enacted at the same time and for a similar purpose, provide that an excise tax of 27½ percent shall be imposed on transfers of stock or securities to a foreign corporation unless, *before* such transfer, it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Notwithstanding the similarity of purpose and structure of these sections, Section 1494(b) provides that the tax otherwise imposed by Section 1491 may be abated, remitted, or refunded if, *after* the transfer, it has been established to the satisfaction of the Secretary or his delegate that the prescribed tax avoidance purpose did not exist. The legislative history discloses no reason for withholding similar relief from the impact of Section 367, which has been and continues to be a trap for the unwary.

To correct this situation, it is suggested that the first sentence of Section 367 be amended as follows:

"In determining the extent to which gain shall be recognized in the case of any of the exchanges described in Section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered a corporation unless it is established, either before or after the exchange, that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes."

Public Law 91-681 generally follows the philosophy of this recommendation but does not go far enough in providing a solution.

SECTION 381

Obligations of Distributor or Transferor Corporations

Section 381(c)(16) should be repealed and Section 381(c)(4) should be amended to eliminate inconsistencies which have led to the loss of deductions for obligations of the distributor or transferor assumed by the acquiring corporation.

When an acquiring corporation is determined to have negotiated for the assumption of obligations of the transferor corporation in a reorganization described in Section 381(a)(2), Section 381(c)(16) provides that the rules of Section 381(c)(4) shall apply regarding methods of accounting to be used after the transaction. The application of these rules has led to inconsistent positions on the part of the IRS in which certain obligations such as reserves for warranties and pension costs result in no deduction to either the transferor or acquiring corporation. The IRS has taken the position that the transferor is not entitled to the deduction because the item is not yet accruable for tax purposes; it also takes the position that the acquiring corporation is denied the deduction because it is the financial liability of the transferor corporation.

Section 381(c)(16) should be repealed and Section 381(c)(4) should be amended to make it clear that one of the parties to the reorganization should be entitled to the deduction.

SECTION 382

Attribution Rules Under Section 382(b)(3)

Section 382(b)(3) should be amended to allow the attribution rules under Section 318 to apply in corporate arrangements involving family members.

For various purposes in numerous provisions throughout the Code, the stock holdings of a family group are aggregated, and each member is treated as owning the stock of other members. This is reflected in the many references to attribution rules under Sections 267(c), 318, 544(a), and 1563(e). The controlled group concept for brother-sister corporations under Section 1563 has been expanded by the Tax Reform Act of 1969. It is therefore recommended that Section 382(b)(3) be amended to make the rules of Section 318 apply in corporate arrangements involving family members.

It appears the possibility of tax avoidance as a consequence of such an amendment would be minimal in view of the provisions and limitations of Sections 269 and 381. In Revenue Ruling 67-202 (1967-1 CB 73), the IRS took the position that there must be legitimate business reasons for the combination of two corporations owned by the same shareholder to support the acquisition of loss carryovers under Section 381.

Furthermore, the lack of attribution rules in Section 382(b)(3) tends to cause family members to go through complicated valuation shifts to permit the owners of a loss corporation to wind up with 20 percent in value of the acquiring corporation. These efforts to avoid the import of Section 382(b)(1) result in unnecessary disputes and litigation over valuation which would not arise if attribution were provided.

SECTION 382

Limitation on Denial of Net Operating Loss Carryover

The denial of carryover loss should be restricted to losses that occurred or economically accrued before the change in stock ownership. [Section 382(a)(1)]

Because of the present wording in Section 382(a)(1), were there a change in ownership and a change in business at the beginning of a taxable year and a corporation had a net operating loss in that year, that net operating loss would be denied as a carryover to subsequent years. This result probably was not intended, as is indicated by *Clarksdale Rubber Co.,* 45 TC 234 (1965), and other similar decisions. Further, diversity of opinions between circuit courts and, with respect to one taxpayer, diversity of application of other Code sections require clarification of this area (*Hall Paving Co.,* CA-5, 471 F2d 261 (1973)). The denial should be limited to losses that were realized before the change in stock ownership and to losses that economically accrued before such date but were realized by sale or other transaction after such date. The limitation on "built-in" deductions in Regulations Sections 1.1502-15 in reference to consolidated returns provides an example of recognition of the recommended approach for limitations on losses accruing before change in stock ownership.

SECTION 382

Period Over Which Changes in Stock Ownership Are Measured

In making a comparison of stock ownership for purposes of Section 382(a), the earlier date should be "twenty-four months before the end of the taxable year." [Section 382(a)(1)]

Section 382(a) provides a period of time over which a change in ownership is measured. This period should be a uniform period, such as twenty-four months, and should not be shortened merely because a taxpayer has a short taxable year or because the acquisition is timed so that the change in stock ownership takes place at or near the end of the taxpayer's year. Short years may arise from entering into or withdrawing from a consolidated group or from a change in fiscal year. A properly timed acquisition can also satisfy the Section 382 test of two taxable years by providing a period covering the last day of a taxable year and all of the succeeding taxable year. For example, assume the loss corporation is on a calendar year. An acquisition on December 31, 1970 would be outside the scope of the Section 382(a) prohibition if the loss corporation does not change its business until January 1, 1972. This encompasses two taxable years—that is, the year ended December 31, 1970 and the year ending December 31, 1971. Neither of these situations should result in a reduction in the period of time for testing changes in stock ownership.

Accounting Periods and Methods

SECTION 452

Taxation of Unearned Income and Allowance of Deductions for Estimated Expenses

Sections 452 and 462 of the Internal Revenue Code of 1954 should be reenacted. Section 452 related to deferral of income received for performance or delivery of service extending beyond the end of the taxable year in which such income is received. Section 462 allowed a deduction for reasonable additions to reserves for estimated expenses.

Unearned income. One of the basic principles of accounting is that income is validated by the delivery of goods or services accompanied by the receipt of cash or a claim for cash. Clearly, equity dictates that a business should not have to pay tax on money that is received but not yet earned, that is, where such receipt is burdened with an obligation to render service, and so forth, beyond the taxable year of the receipt. The present provisions of Section 455 dealing with prepaid subscription income and Section 456 dealing with certain prepaid dues income, although not completely adequate, do recognize this important principle. Regulations Section 1.451-5, Revenue Procedure 71-21, (1971-2 CB 549), and Revenue Ruling 71-299, (1971-2 CB 218) also recognize this principle and provide partial solutions for the problem.

A statutory provision should apply to receipts that carry a definite liability to furnish goods or services in the future. There should be no requirement as to any particular length of time subsequent to the end of the taxable year in which the liability to perform must be satisfied. If a maximum deferral period is considered necessary, it should not be less than five years.

Taxpayers should be permitted the option of electing the deferral treatment as to classes of unearned receipts. This would permit immaterial items to be treated on a nondeferral basis.

It is recognized that an adjustment may be required during a transitional period in order to prevent substantial distortion of income.

Estimated expenses. For taxpayers on the accrual basis, another basic accounting principle concerns the matching of deductions and expenses of a fiscal period with the revenues applicable to such period, even when it is necessary to estimate the amount of such deductions and expenses.

At the time Section 462 was repealed (originally enacted in the Code of 1954), Congress expressed its endorsement of the basic principle of allowing taxpayers deductions for reasonable additions to reserves for estimated expenses, with adequate safeguards to prevent the possible abuses that were feared under Section 462 as originally enacted.

A new provision allowing deductions for estimated expenses should now be enacted, with the following limitations, to make the provision workable and to gain additional experience with the problems that might be encountered.

1. The categories of estimated expenses for which reasonable additions to reserves would be deductible should be limited at the outset to liabilities to customers, to employees, and to claims for multiple injury and damage. Provision for estimated liabilities to customers would include, for example, liabilities for cash and trade discounts, advertising allowances, allowances for defective merchandise, and so forth. Liabilities to employees would include, among other things, liabilities for workmen's compensation claims. Liabilities for multiple injury and damage claims should be restricted to the potential liability estimated on the basis of events that occurred before the close of the taxpayer's taxable year.
2. Taxpayers should be permitted the option of electing to deduct additions to reserves for estimated expenses on an item-by-item basis. A requirement for an all-inclusive treatment covering every conceivable item of eligible estimated expense would carry the danger of a greater revenue impact and of attempts by taxpayers to claim deductions for items that may ultimately be held to be improper in an effort to protect the validity of their election. An item-by-item election would permit taxpayers to deduct only those estimated expenses that are substantial in amount and that the taxpayers reasonably feel are contemplated within the scope of deductibility of estimated expenses.
3. In order to prevent any immediate unfavorable effect on tax revenues, a transitional adjustment may be required.

SECTION 453

Elimination of Double Taxation Upon Change From Accrual to Installment Basis

Upon a change from the accrual to the installment basis of reporting taxable income from installment sales by dealers in personal property, installment payments actually received during the year on account of sales made in a taxable year before the year of change should be excluded in computing taxable income for such year of change and for subsequent years. [Section 453(c)]

Under the Internal Revenue Code of 1939 a taxpayer changing from the accrual method to the installment method was not permitted to exclude from gross income for the year of change and subsequent years the gross profit which had been included in income and taxed in an earlier year when the taxpayer was on the accrual basis. The result was that such taxpayer was taxed twice on the same income.

The Committee Reports accompanying the Internal Revenue Code of 1954 state that with the intention of eliminating this double taxation, Congress enacted Section 453(c) of the Internal Revenue Code of 1954. Unfortunately, that section does not go far enough, for it still requires that the gross profit from installment payments received after the change to the installment method be included in gross income in the year of receipt even though it had previously been taxed under the accrual method.

Actually, Section 453(c) does not accomplish its intended purpose. Only limited relief is provided from the double tax penalty. Even if it is assumed that the tax rate and gross income is the same for the earlier year and the year of change, the net income and the final tax in the earlier year would probably have been smaller because the expenses of sale would have been deducted in the earlier year under the accrual method. Thus, the Section 453(c) adjustment will not eliminate all the tax in the second year resulting from the inclusion of the gross profit. The double tax of Section 453(c), however, can be fully avoided by selling the receivables prior to the election to report on the installment basis. Although this technique does provide relief from the double tax, it adds to the incongruity of Section 453(c).

In order to accomplish equity between taxpayers who change from the accrual to the installment method of accounting for installment sales, taxpayers who adopted the installment method originally, and taxpayers who sell their receivables prior to changing to the installment method, and, in order to bring about the expressed intent of the Congress, Section 453(c) should be amended to permit a changeover to the installment method without double taxation.

SECTION 453

Open-End Sales

Section 453(b) should be amended to provide for installment sale reporting in any open-end sale where payments in the year of sale do not exceed 30 percent of the minimum sales price.

Section 453(b) allows use of the installment sales method, provided payments in the year of sale do not exceed 30 percent of the selling price. The IRS maintains that to qualify for installment sale reporting, a fixed and determinable selling price must exist at the time of the sale. In *Gralapp,* CA-10, 458 F2d 1158 (1972), the Tenth Circuit Court of Appeals upheld the Commissioner in deciding that an open-end sale does not qualify for installment sale reporting. However, the court, by dicta, indicated that this decision should not be considered absolute in all situations involving open-end sales.

We recommend that Section 453 be amended to provide for installment sale reporting where payments in the year of sale do not exceed 30 percent of the minimum sales price. Contingent payments received in subsequent years would adjust gross profit to be reported similar to the method approved by the Commissioner in Revenue Ruling 72-570, (1972-2 CB 241). We believe this provision would be equitable and in accord with the intent of Congress in enacting Section 453—namely, to provide a relief measure from the payment of tax on the full amount of anticipated profits when only a small part of the sales price has been paid in cash. Open-end sales frequently arise as a result of honest differences of opinion as to the real value of property sold. Where these differences of opinion exist, it may not be possible to complete the sale without use of installment reporting, because the seller would owe more tax on the sale than the amount of payments received in the year of sale.

This amendment would not only provide sellers an opportunity to consummate such sales with assurance about the resulting tax treatment, but would also eliminate much of the controversy that arises from the alternative use of the "deferred payment method" of reporting.

SECTION 472

Last-In, First-Out Inventories

The issuance of annual reports that include disclosure of information consistent with the requirements of regulatory or other authoritative bodies that promulgate generally accepted accounting principles should not violate the LIFO method conformity requirements. [Sections 472(c), 472(e)]

Section 472(c) presently provides that a taxpayer may not properly elect to use the LIFO inventory method for federal income tax purposes unless it establishes to the satisfaction of the IRS that, for the taxable year of election, it has used no procedure other than LIFO to ascertain the income, profit, or loss for purposes of an annual report to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. Section 472(e) provides that the same "conformity" type of requirement applies to the continued use of the LIFO method for future taxable years. Thus, where there is a variance between the LIFO method used for tax purposes and the method used to ascertain income, profit, or loss for annual financial reporting purposes, the IRS may terminate the LIFO election for a violation of these conformity requirements.

An "annual report" for these purposes apparently includes all the numerical data, footnotes, and commentary contained in any report covering the entire taxable year, including annual financial statements, annual reports, annual news releases, and so forth.

The audited annual financial statements of corporate and other business taxpayers must be presented in accordance with generally accepted accounting principles, and often must include disclosure therein of information that may be technically in violation of the conformity requirement. In the case of companies registered with the SEC, such disclosures may be necessary in order to satisfy the requirements of that agency's reporting and disclosure rules and regulations according to the provisions of the Securities Acts of 1933 and 1934. Such rules and regulations have been modified from time to time to require more complete disclosure of financial information consistent with the purposes of those acts. Moreover, the SEC rules embrace the disclosure requirements of generally accepted accounting principles. Those principles are promulgated by an authoritative accounting body, such as the Financial Accounting Standards Board for periods since July 1973, and prior thereto by the Accounting Principles Board of the American Institute of Certified Public Accountants. In addition, a certified public accountant who is a member of the AICPA is prohibited by the rules of conduct governing his professional activity from "expressing his opinion that financial statements are presented in conformity with generally accepted accounting principles if the statements depart in a material respect from such principles, unless he can demonstrate that due to unusual circumstances application of the principles would result in misleading statements—in which case his report must describe the departure, its approximate effects, if practicable, and the reasons why compliance with the established principles would result in misleading statements."

In applying the provisions of Section 472(c) and (e), the IRS has generally acknowledged the practical need to accommodate the differences between the financial reporting disclosures necessary to satisfy the requirements of the SEC and/or generally accepted accounting principles, and the literal requirements of Section 472(c) and (e), so as not to preclude the use of the LIFO method by taxpayers. See, for example, Revenue Ruling 74-586 and the four prior rulings discussed therein.

The development of new and more complete disclosure requirements for financial reporting purposes is increasing substantially, and this process is likely to continue. For affected taxpayers who must as a practical matter issue annual financial reports, and so forth, with full disclosure on a timely basis, this has caused delays and uncertainty regarding such reports. Moreover, the establishment of other financial reporting disclosure requirements by the SEC and/or the FASB may be unduly hampered by the statutory inflexibility of present law.

Therefore, Section 472(c) and (e) should be amended to accommodate automatically any financial reporting disclosures that are required pursuant to the rules, regulations, or practices of regulatory bodies such as the SEC, or that are required in order to satisfy generally accepted accounting principles as promulgated in writing by an authoritative accounting body such as the FASB. To avoid the establishment of different standards for companies registered with the SEC and smaller taxpayers, this amendment should apply to all taxpayers who use the LIFO method, whether or not they are subject to SEC jurisdiction.

SECTION 482

Mitigation of Statute of Limitations in Related Taxpayer Cases

Whenever the Secretary of the Treasury exercises his right to reallocate income or deductions between or among two or more taxpayers, either the party whose income is decreased or whose deductions are increased by such reallocation should be permitted to pick up the effect of the adjustment without regard to the statute of limitations, or no reallocation should be made under Section 482.

Section 482 permits the Secretary to reallocate income and deductions among related taxpayers where, in his opinion, action is necessary to reflect properly the income of the respective related taxpayers. Where such allocations are made, correlative adjustments to the income of related taxpayers involved in the allocations are required by the Regulations where not otherwise barred by law. Often, an increase in taxable income of one of the parties is determined at a time when the statute of limitations with respect to one of the related taxpayers has already expired. This bars a tax refund for such other party which otherwise would be obtainable. Thus, after having collected the tax from one taxpayer, the Secretary can refuse a refund of tax to the other taxpayer affected. In this situation the same income is taxed twice.

The party whose income is decreased or whose deductions are increased by a reallocation under Section 482 should be accorded the right of a correlative adjustment without regard to the statute of limitations. Alternatively, the Section 482 adjustment should not be permitted if the correlative adjustment is barred by the statute of limitations.

Exempt Organizations

SECTION 501

Tax Treatment of Certain Cooperative Housing Associations

In the case of homeowners associations, condominium housing associations, and cooperative housing corporations, only the net investment income and net income derived from a trade or business should be taxable.

Because of the IRS interpretation of the language of Section 501 (c)(4), condominium housing associations and homeowners associations generally do not now qualify for exemption from federal income tax. These associations are supported by periodic assessments against the members who are the owners of condominium units or the owners of residences in a real estate development. The funds are used for the management, maintenance, or operation of the common areas of the projects. Part of the funds are used to build up reserves to be used for future maintenance, repairs, or replacement of the common facilities. As such, these funds actually represent the savings of the unit owners and should not be subjected to federal income tax.

These cooperative housing associations should be taxed only on their net investment income and net income derived from a trade or business. Assessments for the administration, maintenance, operation and capital improvement of the homeowners associations, should not be taxable.

To correct this situation, Subchapter F should be amended to provide for exemption for these associations on qualifying membership dues, fees, or assessments. To be sure that the exemption is not abused, it should be limited to those associations deriving 80 percent or more of their gross income from association members.

Corporations Used to Avoid Income Tax on Shareholders

SECTION 534

Burden of Proof

Section 534 should be amended to provide that the burden of proof is always on the Secretary or his delegate irrespective of the court in which the case is tried or any pleading by the Secretary or his delegate.

Under present law, Section 534 shifts the burden of proof to the Secretary or his delegate in an accumulated earnings tax case in the Tax Court if the taxpayer files "a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any of the earnings" have not been unreasonably accumulated.

In cases having arisen to date involving the Sec. 534(c) statement, the Secretary or his delegate, in answering the taxpayer's petition to the Tax Court, has generally denied the sufficiency of the grounds and adequacy of the facts set forth in the Section 534(c) statement and has generally pleaded an affirmative answer. Only in rare instances has the Tax Court found a taxpayer's statement sufficient to shift the burden of proof. Experience has shown that more often than not the taxpayer's statement of facts in support of the stated "grounds" for the accumulation was found wanting.

It has been a traditional concept of tax procedure that the taxpayer should be allowed to select the forum that is most convenient to him. Accordingly, if the burden of proof can be shifted to the Secretary or his delegate in deficiency proceedings, it should also be possible to shift it to the government in refund proceedings.

The tax imposed by Section 531 on corporations improperly accumulating surplus is a penalty tax rather than a tax on income. In any proceeding, the burden should be on the Secretary or his delegate to show that a penalty is warranted, rather than on the taxpayer to show that a penalty should not be assessed. Accordingly, it is recommended that the filing by a taxpayer of a Section 534(c) statement in an accumulated earnings tax proceeding should shift the burden of proof to the Secretary or his delegate in all cases irrespective of (1) the court in which the case is tried and (2) any pleading the Secretary or his delegate may file with respect to the sufficiency of the statement. The requirement of a statement of facts in a Section 534(c) statement should be eliminated.

SECTION 563

Dividends Paid After Close of Taxable Year by Personal Holding Companies

Section 563(b) should be amended to provide that dividends paid within the time for filing the federal tax return (including extensions) for a particular taxable year will be considered as paid during such taxable year to the extent such dividends do not exceed undistributed personal holding company income. To prevent tax avoidance, this amendment would be limited to companies which have not been personal holding companies in any of the three preceding taxable years.

Section 563(b) presently provides that a personal holding company (PHC), in computing its undistributed PHC income, may elect to deduct dividends paid within two and one-half months after the end of a taxable year as paid on the last day of that year. But the deduction cannot exceed either the undistributed PHC income of the taxable year or 20 percent of the actual dividends paid during the taxable year.

The purpose of Section 563(b) is to allow additional time after the close of the taxable year for a company to determine accurately its PHC income so it can pay out the dividends required to eliminate the penalty tax. However, the 20 percent limitation in Section 563(b)(2) is too restrictive to allow the provision to accomplish this purpose. Many companies do not know the extent or existence of their PHC problem until after year end because of the difficulties of estimating their income and the complexities in determining PHC status before year end. Thus, the requirement that about 83 percent of the required dividends must be paid during the taxable year to use the 20 percent "after-year" dividend provision may actually afford little assistance to a company unknowingly caught in a PHC trap. Furthermore, repeal of this limitation would in no way affect the primary purpose of this penalty tax, which is to compel a distribution to the stockholders so that an income tax can be collected from them on the dividends received.

Therefore, Section 563(b) should be amended to provide that dividends paid within the time for filing the federal tax return (including extensions) for a particular taxable year will be considered as paid during such taxable year to the extent such dividends do not exceed undistributed personal holding company income. To prevent abuses by shareholders of PHCs who would continuously defer dividend distributions to the following year, this amendment would be limited to companies which have not been PHCs in any of the three preceding taxable years.

Banking Institutions

SECTION 593

Bad Debt Reserves of Mutual Savings Banks, Etc.

Section 593(c)(1) should be amended to provide specifically that record-keeping requirements concerning bad debt reserves will be met if the taxpayer is able to provide, at the time of an examination, information sufficient to enable the IRS to determine whether amounts claimed by the taxpayer as deductions for additions to bad debt reserves are within the prescribed limitations.

Mutual savings banks and savings and loan associations have had difficulties with the record-keeping required by the IRS in accounting for bad debt reserves. Severe penalties, namely, forfeiture of otherwise allowable deductions, can arise for failure to comply. (See *Leesburg Federal Savings & Loan Association,* 55 TC 378 (1970).) A taxpayer who can establish his intention, and thus cannot prejudice the Treasury's position, should not be denied a deduction provided by the Code, and it is doubtful whether Congress would have so intended. Congress should clarify Section 593 to recognize that a taxpayer's intent, rather than formalistic bookkeeping requirements, should govern. This might be shown by the claiming of the deduction itself in the return, or by including computations of the deduction and various limitations on schedules attached to the return.

Estates, Trusts, Beneficiaries and Decedents

SECTION 642

Unused Investment and Foreign Tax Credits on Termination of an Estate or Trust

The investment and foreign tax credits not used by the estate or trust should be available as a carryover to the beneficiaries succeeding to the property of the estate or trust. [Section 642(h)]

Present law provides for the carryover of a net operating loss, a capital loss, and the excess of deductions over gross income in the last taxable year to the beneficiaries succeeding to the property of the estate or trust. It is equitable for the beneficiaries also to be allowed the benefit of the unused investment and foreign tax credits.

SECTION 642

Separate Shares—Partial Termination

The deduction carryover provisions of Section 642(h) should be extended to the termination of a single beneficiary's entire interest in a trust having different beneficiaries where such interest represents a separate share as determined under Section 663(c).

The deduction carryover provision of Section 642(h) applies only upon the final termination of an estate or trust. The provision should be extended so as to include an apportionment of such deductions when there is a final termination as to a single beneficiary's separate share in a trust where there are several beneficiaries.

SECTION 663

Corpus Distributions

The definition of the types of gifts and bequests which are excluded from the gross income of beneficiaries of estates and trusts should be expanded. [Section 663(a)]

Payments of certain specific bequests or gifts of specific sums of money or specific property are not deductible from distributable net income of the estate or trust. Such payments are not includible in the income of the recipient. However, other distributions of the same nature and character result in a distribution of taxable income, and are taxed to the recipient, because they fail to meet the test of the exclusion in the Code. The Section 663 exclusion test should be liberalized to permit exclusion from income of a beneficiary of

1. All bequests or gifts, unless payable solely from income, if paid all at once or within one taxable year of the estate or trust, or, in the case of installment payments, if distributed before the close of the thirty-sixth month after the death of the testator.
2. Any real property, tangible personal property (except money), or stock in a closely held corporation which is properly distributed within the thirty-six months following the death of the decedent.

SECTION 665

Throwback Provisions

The provisions applicable to the distribution of accumulated income by trusts should be simplified. There should be one method of computing the tax on accumulation distributions. The accumulation rule should not apply to income earned for a beneficiary before age 21, and there should be a *de minimus* rule below which there will be deemed to be no accumulations. The throwback rules should not apply to capital gains nor should they apply to accumulations after a ten-year period. [Sections 665, 668, 669]

The rules concerning the taxation of distributions of accumulated trust income are unduly complex and burdensome. The Code should be amended to

1. Provide one method for determining the tax on the distribution of the accumulated income similar to the present provision of Section 668(b), but with the income being added to taxable income rather than gross income.
2. Eliminate the application of the throwback rules to income accumulated prior to the existence of the beneficiary and prior to a beneficiary's reaching 21 years of age.
3. Provide that no recomputations will be required or permitted concerning those years in which the undistributed net income does not

exceed $1,000. It should be further provided that this exception will not be applicable if a person is a beneficiary for more than one trust and the total undistributed net income that might be applicable to him for that year exceeds $1,000.

4. Eliminate the application of the throwback rules to capital gains.
5. Limit the applicability of the accumulation trusts rules to income accumulated in the previous ten years.

The adoption of these provisions would prevent the use of the complex throwback provisions in those instances where little or no tax abuse is involved. It would eliminate the application of the rules to many trust situations in which there is no specialized technical advice available to the trustee and beneficiary. It is believed that in many instances where small trusts are involved the parties do not have available the type of professional assistance necessary to cope with the problems of the throwback provisions. Further, the ten-year limitation on the throwback rule is deemed to be absolutely essential because of the onerous record-keeping requirements that would otherwise be necessary. It is not reasonable to expect beneficiaries to retain records for more than ten years, particularly when it is considered that in certain instances the person to whom the throwback provisions would be applied may not even be aware that the potential application exists. The use of the ten-year throwback provision is deemed to be sufficient to eliminate most abuse situations. In those instances where the beneficiary does not have the use of the funds for a period in excess of ten years, it is deemed to be unwarranted to have him pay the tax on those funds.

SECTION 665

Undistributed Net Income—Limit Amount to "Income" Under Governing Instrument

The definition now contained in Section 665(a) may result in an application of the throwback rule to items that were not previously distributed because they were not "income."

The term undistributed net income is defined as the excess of distributable net income over the sum of the amounts distributed or required to be distributed and the taxes paid. This amount can include items which are not "income" under state law and under the governing instrument.

For example, the trust may have received a corpus distribution from an estate. The distribution may have resulted in an inclusion in the trust's gross income of part of the estate's distributable net income under the provisions of Section 662(a). The trust, however, has no income under state law.

To avoid the throwback provisions from applying to items that are not income, Section 665(a) should contain a limitation based upon the provisions of state law and the governing instrument.

SECTION 691

Income in Respect of Decedents

The income tax deduction for the estate tax attributable to income in respect of a decedent should be replaced by an estate tax deduction for the income tax attributable to such income.

The purpose of the Section 691(c) deduction is to relieve a double tax situation and place the decedent's estate or heir in the same position as the decedent would have been had he realized the income during his lifetime and paid the income tax thereon. Present law provides for a deduction of an attributable portion of estate tax as an income tax deduction rather than an attributable portion of income tax on this income as a deduction for estate tax purposes. The provision of a deduction for income tax purposes, rather than an income tax deduction for estate tax purposes, appears to have been made for administrative expediency; it results in difficult, complicated computations and can produce inequitable results.

It is recommended that the deduction permitted by Section 691(c) to persons who include in gross income, income in respect of a decedent under Section 691(a), should be replaced by rules which would permit a deduction for estate tax based upon the amount of income tax which would be deemed attributable to all items includible as income in respect of a decedent under Section 691(a), less deductions allowed under Section 691(b). This method would give a result that more nearly represents the actual tax effect that would have prevailed if the decedent had realized the income prior to his death. The amount of income tax which would be deemed attributable to these items of income and deductions would be determined by reference to the decedent's income tax rates. Specifically, the decedent's income tax for the three years prior to the year of death would be recomputed by including in each year one-third of the net of the Section 691(a) and (b) items. The resultant increase in tax would represent the amount of the deduction to be taken in computing the taxable estate.

Partners and Partnerships

SECTION 703

Partnership Organizational and Reorganizational Expenditures

Section 703 should be amended to permit partnerships to deduct organizational and reorganizational expenditures.

Present law in Section 248 provides for deduction of corporate organizational expenditures. Section 703 should be amended to provide parallel treatment for partnerships. This would include a deduction for expenditures incident to the creation of the partnership and preparation of the partnership agreement.

The recommendation for Section 248 suggests expanding the deduction under Section 248 to cover reorganizational expenditures. Partnerships should receive parallel treatment.

SECTION 703

Deficiency Elections for Partnerships

Section 703(b) should provide that elections permissible at the partnership level will be considered timely if made in connection with a determination that a partnership in fact exists, notwithstanding the failure to have made such elections on a timely filed partnership return.

Code Section 761 provides only a brief definition of a partnership. It is possible that an examination by the IRS may result in the determination that an operational format utilized by taxpayers was in fact a partnership under Section 761. Where taxpayers have acted in good faith in reporting taxable income or loss predicated on the belief that a partnership did not exist, they should not be penalized for failure to make otherwise allowable elections on a partnership return. Accordingly, the concept of an elective deficiency remedy, similar in intent to that of Section 547 regarding deficiency dividends, should be made applicable under Section 703(b). It should cover situations in which an IRS determination that a partnership exists would have the effect of nullifying good faith elections made at the taxpayer level, or would prevent elections at the partnership level which would otherwise have been valid if a timely partnership return had been filed.

SECTION 706

Closing of Partnership Year

The taxable year of a partnership should close with respect to a partner who dies unless his personal representative elects otherwise. [Section 706(c)(1)]

Present law provides that the taxable year of a partnership does not close with respect to a partner who dies, unless as a result of such death, the partnership is terminated or a sale or exchange of the decedent's interest in the partnership occurs on the date of death. This provision prevents bunching of income in the final return of a decedent partner where otherwise two partnership years could close in such year. However, the inability to include such income in the decedent's final return many times results in the loss of deductions and exemptions which could otherwise be offset against the decedent's share of partnership income to the date of death.

It is recommended that the present rule be amended to provide that a partnership year with respect to a deceased partner shall close as of the date of such deceased partner's death, unless the deceased partner's personal representative or other person responsible for filing the decedent's final tax return elects to continue such partnership year for the decedent partner's interest.

SECTION 754

Basis Adjustment of Partnership Property for Gift Tax Paid

The Section 754 election should be applicable to transfers by gift where the donor's basis is increased by the gift tax paid on transfer of the partnership interest.

The optional adjustment to basis of partnership property pursuant to election under Section 754 is designed to reflect basis in partnership assets on transfer of a partnership interest when the transeferor's basis does not carry over to the transferee, such as in the case of a distribution of property under Section 734(b) or the transfer of a partnership interest by sale or exchange or on death under Section 743(b). Although transfer of a partnership interest by gift involves carryover of the donor's basis, the adjustment to basis in the hands of the transferee as a result of the gift tax paid, can be substantial. Accordingly, it is recommended that transfer by gifts be covered by the Section 754 election, subject to an exclusion for *de minimus* gift taxes, in order to enable such additional basis to be reflected in partnership assets on behalf of the transferee.

Regulated Investment Companies

SECTION 852

Deficiency Dividends for Regulated Investment Companies

Where a regulated investment company has acted in good faith in distributing 90 percent of its taxable income, the dividends-paid deduction also should take into account deficiency dividends, similar to those determined under Section 547, if the taxpayer's taxable income is increased upon examination so that the 90 percent requirement is not met. [Section 852(a)(1)]

Section 852(a) provides that a regulated investment company must distribute 90 percent of its taxable income in dividends. It is possible that an examination by the IRS may change the taxpayer's taxable income significantly, resulting in a tax liability because, as a result of the increase in taxable income, the taxpayer does not meet the 90 percent requirement.

The provisions regarding deduction for deficiency dividends, such as those of Section 547, should be made applicable with respect to situations in which a Service examination causes a regulated investment company to fall below the 90 percent requirement when prior to the examination the trust, in good faith, had distributed 90 percent of its taxable income.

Real Estate Investment Trusts

SECTION 856

Commitment Fees Received by Real Estate Investment Trusts

The limitations applicable to qualifying gross income of a real estate investment trust should be expanded to include fees received for making a commitment to loan money on real estate. [Section 856(c)]

Section 856(c) provides that a trust or association shall not be considered a real estate investment trust unless 90 percent of its gross income is derived from passive sources, such as dividends, interest, real property rents, gains on stock, securities, and real property, and real property tax abatements and refunds. In addition, at least 75 percent of such passive gross income must specifically result from real property interests, mortgages thereon, or other real estate investment trusts.

Although it is common practice for real estate investment trusts to take commitment fees in connection with mortgage loans, such fees are not within the enumerated permissible passive sources of gross income and, therefore, receipt of such fees may result in disqualification of the trust.

Accordingly, it is recommended that the statute be amended to treat commitment fees as qualifying source income for purposes of the 90 percent and 75 percent gross income tests.

"Commitment fees" should be defined as all fees received for making a commitment to loan money on real estate or to acquire interests in real estate. Such definition would, therefore, encompass commitments commonly referred to as "standby" or "takeout" fees, as well as commitment fees applicable to the purchase and leaseback of real property.

SECTION 857

Deficiency Dividends for Real Estate Investment Trusts

Where a real estate investment trust has acted in good faith in distributing 90 percent of its taxable income, the dividends-paid deduction also should take into account deficiency dividends, similar to those determined under Section 547, if the taxpayer's taxable income is increased

upon examination so that the 90 percent requirement is not met. [Section 857(a)(1)]

Section 857(a) provides that a real estate investment trust must distribute 90 percent of its taxable income in dividends. It is possible that an examination by the IRS may change the taxpayer's taxable income significantly, resulting in a tax liability because, as a result of the increase in taxable income, the taxpayer does not meet the 90 percent requirement.

The provisions, such as those of Section 547, regarding deduction for deficiency dividends, should be made applicable with respect to situations in which a Service examination causes a real estate investment trust to fall below the 90 percent requirement when prior to the examination the trust, in good faith, had distributed 90 percent of its taxable income.

Tax Based on Foreign Income

SECTION 864

Force-of-Attraction Doctrine

The limited vestige of the force-of-attraction doctrine should be repealed so that U.S. source business-type income which is in no way related to the activities of a U.S. trade or business should not be treated as effectively connected income subjected to U.S. tax. [Section 864(c)(3)]

Prior to the enactment of the Foreign Investors Tax Act in 1966, the taxation of a foreign taxpayer in the Code was based on the "force-of-attraction" principle, under which, if the foreign taxpayer was engaged in trade or business in the United States, all U.S. source investment and unrelated business income was "attracted" to and treated as part of the trade or business and thereby subjected to U.S. tax at regular rates.

The Foreign Investors Tax Act abandoned this principle as at January 1, 1967, and substituted therefor the "effectively connected" concept, under which a foreign taxpayer engaged in a U.S. trade or business is taxed at regular rates only on his business income (although the "effectively connected" concept does attract to U.S. tax certain items of foreign source business income). U.S. source income not connected with a U.S. business, usually investment income referred to in the Code as "fixed and determinable annual and periodical gains, profits and income," is only taxed at regular rates when that income is "effectively connected" with the conduct of a trade or business in the United States; otherwise it is not "effectively connected" and is taxed at a flat rate of 30 percent on gross income (or lower treaty rate where applicable).

Under Section 864(c)(3), however, not effectively connected U.S. source income which does not fit into the definition of fixed and determinable annual and periodical gains, profits and income is treated as "effectively connected" and taxed at regular rates. Thus, even though such income is not factually "effectively connected" with a U.S. trade or business, it is still taxed as such. To this degree, there still exists the anachronistic "force-of-attraction" principle.

This rule is illustrated by example (3) of Regulations Section 1.864-4(b) as follows:

> Foreign corporation X is engaged in the business of buying and selling of electronic equipment and has a branch office in the United States to sell electronic equipment to customers in the U.S. and elsewhere. The home office of foreign corporation X also is in the business

of buying and selling vintage wines. However, the U.S. branch is not equipped to sell and does not participate in the sales of vintage wines. By virtue of the activity of its sales branch, foreign corporation X is engaged in trade or business in the U.S. However, sales which do not relate to the U.S. branch are still treated as effectively connected income. Thus, if the home office directly makes sales of the vintage wines in the U.S. without routing such sales through its U.S. branch, that income is considered effectively connected with the conduct of a trade or business in the United States.

U.S. tax policy made great strides forward when it adopted the "effectively connected" concept, since such concept is more in keeping with economic and business realities. In the above example, for instance, since the wine sales are not in any way the result of economic or business activities of the U.S. branch, there is no reason, as a matter of policy, for the U.S. to tax the income from the wine sales. Accordingly, Section 864(c) should be eliminated from the Code, or such other amendments should be made which would completely bury the "force-of-attraction" doctrine.

SECTION 904

Carryback of Excess Foreign Income Taxes

The two-year carryback provisions of the excess of foreign income taxes paid or accrued over the applicable limitations of Section 904 should be changed to three years. [Section 904(d)]

Section 904(d) provides that any foreign income taxes that are paid or accrued to any foreign country and that exceed the applicable limitations of Section 904(a) are carried back two years and then forward five years.

The carryover concept of excess deductions and credits is employed in other areas of the Code. With respect to the normal types of net operating losses, capital losses and unused investment tax credits, a three-year carryback period has been determined by Congress to be the most appropriate and the Code so provides. For some reason, however, the three-year carryback period has never been extended to Section 904(d).

In the interest of consistency in the Code, the three-year carryback provisions for net operating losses, capital losses, and unused investment tax credits should be adopted with respect to excess foreign income taxes. Such conformity would be achieved by amending the foreign tax carryback provisions from two years to three years.

SECTION 911

Definition of Earned Income of Unincorporated Business for Purposes of Section 911

The exclusion of earned income from foreign sources provided under Section 911 should apply to net business income where business is unincorporated.

Considerable inequity exists where earned income from unincorporated business activities is defined with respect to gross income, rather than net income, from such business. If the exclusion is applied at the gross income level, the proportionate part of the business deductions applicable to the excluded gross income are nondeductible. The result is to permit, in every case, an exclusion of an amount less than the $20,000 or $25,000 maximum specified in the statute.

Such an approach discriminates against the self-employed or members of a partnership. If a sole proprietor or partner who has been a bona fide resident of a foreign country for more than three years has gross income of $100,000 and net income of $25,000 from a business in which capital is not a material income-producing factor, his earned income exclusion would be $25,000 if applied at the net income level and only $6,250 if applied at the gross income level. If the business were incorporated and the taxpayer's salary was equal to the net income of the business, he would exclude the entire salary from gross income. Since the only possible source of any reasonable compensation for personal services in the case of the self-employed is the net profits from the business, any tax benefit should be based on such net profits.

The IRS has apparently interpreted the law to apply the Section 911 exclusion against the gross income derived by a taxpayer from an unincorporated business. The ruling in *Anne M. B. Brewster,* 55 TC 251 (1970), seems to give judicial sanction to the IRS interpretation. Because of the inequity of the result, we believe that Section 911 should be amended.

SECTION 911

Exclusion of Earned Income From Sources Without the United States

The exclusion from gross income of earned income from sources without the United States attributable to presence in another country for seventeen months granted by Section 911(a)(2) should be allowed for all resident aliens.

In general, the tax laws do not distinguish between resident aliens and U.S. citizens. However, in one important respect there is a difference in treatment that results in an inequity to the resident alien.

A resident alien is taxed on his global income just as a citizen. However, if the alien works for an extended period of time outside the United States, he is taxed more severely than any citizen since he is not permitted the earned income exclusion under Section 911(a)(2). There is no basis in reason or equity for this distinction.

The IRS announced its position in Revenue Rulings 72-330 (1972-2 CB 444) and 72-598 (1972-2 CB 451): Aliens residing in the United States who are nationals of certain countries may avail themselves of Section 911(a)(2) benefits by reason of the nondiscrimination clause contained in the income tax treaty between those countries and the United States. Countries covered by nondiscrimination clauses in treaties now include Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Luxembourg, The Netherlands, Norway, Pakistan, Sweden, Switzerland, Trinidad and Tobago, Union of South Africa, and the United Kingdom.

To clarify the application of Section 911 to nationals of treaty countries other than those enumerated in the two rulings cited above and to extend its application to nationals of nontreaty countries (for example, Latin American countries), Section 911 should be amended to permit the exclusion to all resident aliens, irrespective of whether a tax treaty is involved.

SECTION 956

Investment in United States Property Rules

The broad application of the investment in U.S. property rules should be narrowed to cover true constructive dividend situations, since it has

proven to be primarily a trap for the unwary to the uninitiate, and an anti-balance-of-payments pressure to the sophisticate. [Sections 951 (a)(1)(B), 956]

Since 1962, to the extent that a controlled foreign corporation (CFC) increases its investment in U.S. property, the accumulated earnings and profits of the CFC, to the extent of such increase, are deemed distributed to the U.S. shareholders and subjected to current U.S. tax. (The Code defines U.S. property broadly to include almost every property right with exceptions for such items as U.S. government obligations, bank deposits, and certain trade receivables.) Therefore, if a CFC invests its surplus cash in the United States, its U.S. shareholders would be subject to U.S. tax, although a similar type of investment in foreign property would not attract dividend consequences to the U.S. shareholders.

Although there may have been some abuse in this area prior to 1962, the scope of Section 956, as enacted in 1962, is so broad that it extends to many transactions and asset acquisitions which bear no semblance to dividends. For example, the U.S. shareholder of a CFC is subjected to current U.S. tax where the CFC's U.S. investment is made in shares or securities of a wholly unrelated U.S. person. Such an acquisition in no way resembles a constructive dividend since the U.S. shareholder gains no direct economic benefit of an investment by its CFC in such an unrelated U.S. entity. The scope of Section 956 has been expanded (Revenue Ruling 74-436, IRB 1974-36, 12) to the point where a U.S. shareholder can be taxed on an amount *greater* than the largest investment in U.S. property ever made by the CFC, a result which seems unreasonable and unwarranted in the light of what Section 956 was intended to accomplish.

Section 324, Title III of the Energy Tax and Individual Relief Bill of 1974 (H.R. 17488) moves in the right direction by limiting the scope of Section 956 to apply only in cases where the CFC engages in a transaction (share acquisition, loan, or lease) with a related U.S. person. We believe, however, that there is no reason to treat a bona fide and arm's-length leasing transaction between a CFC and a related U.S. person as an investment in U.S. property, although we are in essential agreement with the remainder of this provision.

As long as the income of a controlled foreign corporation is not subjected to current U.S. tax, generally, investments in the United States by the CFC should not subject the U.S. shareholder to U.S. tax (where comparable investments by the CFC can be made abroad without subjecting the U.S. shareholder to current U.S. tax) except where the investment has all the earmarks of being a disguised distribution of earnings and profits (i.e., essentially equivalent to a dividend). This should only occur in debt or equity transactions with a related U.S. party. Such a rule would encourage CFCs to keep surplus cash in U.S. investments other than bank accounts and governmental obligations and should act as a positive factor in the U.S. balance of payments.

In addition to narrowing the definition of U.S. property, the statutory rules of Section 956 for computing the taxable amount of investment in U.S. property should be modified to avoid certain existing inequities. It is a well-settled principle that a corporation must have current or accumulated earnings and profits to make a distribution to its shareholders taxable as a dividend. Accordingly, Section 956 should be amended to preclude constructive dividend treatment to the U.S. shareholder if the CFC

1. has no current or accumulated profits at the close of the year in which it invests in U.S. property, *and*
2. has current earnings and profits in a subsequent year but does not increase its investments in U.S. property.

If there are investments in the subsequent year, the rules should limit the taxation under Section 951(a)(1)(B) to the extent of the amount (basis) of investments made in such subsequent year, and eliminate entirely consideration of investments made in the earlier year(s). There is precedence in the Code for this type of treatment in the Section 306 provisions which except shares otherwise qualifying as Section 306 stock from categorization as such (thus not giving rise to ordinary income upon their sale or exchange), if the issuing corporation had no current or accumulated earnings and profits at time of issuance. A rule of this nature in Section 956 would make the section operate more equitably and reasonably.

SECTION 958

Controlled Foreign Corporation Defined

Section 958 should be amended so that it is not possible for second-tier and lower-tier subsidiaries to be controlled foreign corporations where the first-tier foreign corporation is not a controlled foreign corporation. [Section 958(b)(3)]

Section 957(a) defines a "controlled foreign corporation" (CFC) as any foreign corporation of which more than 50 percent of the total *voting power* of all classes of stock is owned or considered as owned within the meaning of Section 958 by U.S. shareholders. Therefore, a first-tier foreign corporation is not a CFC where more than 50 percent *in value* of its stock is owned by U.S. shareholders, provided the U.S. shareholders do not meet the *voting power* test. However, in such a case, although the first-tier foreign corporation is not a CFC, foreign subsidiaries in which the first-tier foreign subsidiary owns more than 50 percent of the total voting power are CFCs. This result, apparently contrary to congressional intent, is determined as follows:

1. Section 958 provides that for purposes of determining whether a corporation is a CFC under Section 957, the constructive ownership rules of Section 318(a), as modified, shall apply.
2. Section 318(a)(2)(C) as modified by Section 958(b)(3) provides that, if 10 percent or more in value of the stock of a corporation is owned, then the owner shall be considered as owning any stock owned by that corporation in the proportion which the *value* of the stock owned in the first corporation bears to the *value* of all of the stock of such corporation.
3. When applying Section 318(a)(2)(C), Section 958(b)(2) provides that if a corporation owns more than 50 percent of the voting power of all classes of stock entitled to vote, it shall be considered as owning 100 percent of the stock entitled to vote.

An example to illustrate the application of the cited Code sections follows. Assume foreign corporation F owns 60 percent of the one class of outstanding stock of foreign corporations X and Y, and Y owns 60 percent of the one class of outstanding stock of foreign corporation Z. The ownership in F is as follows:

	Number of Shares			*% of Ownership*	
	Total	*Class A (Non-Voting)*	*Class B (Voting)*	*Voting*	*Value*
U.S. Shareholder	550	150	400	48%	55%
Foreign Shareholders	450	25	425	52%	45%
	1,000	175	825	100%	100%

The application of the various sections is as follows:

1. F is not a CFC since U.S. shareholders do not own more than 50 percent of its voting power.
2. Under Section 958(b)(2), F is considered to own 100 percent of X and Y, and Y is considered to own 100 percent of Z when applying Section 318(a)(2)(C).
3. The U.S. shareholder under Section 318(a)(2)(C) is considered to own 55 percent of the stock of corporations X, Y, and Z; thus, they are CFCs.

To remedy this condition, Section 958(b)(3) should be modified to read: "In applying subparagraph (C) of Section 318(a)(2), the phrase '10 percent' shall be substituted for the phrase '50 percent' and the phrase 'voting power' shall be substituted for the word 'value' used in subparagraph (C)."

SECTION 960

Extension of Foreign Tax Credit Under Subpart F Rules to Third-Tier Foreign Corporation

Section 960 of the Code should be amended to allow credit for foreign taxes of third-tier foreign subsidiaries to be comparable to a similar change made in Section 902.

Section 960 provides the authority for taxpayers to claim a foreign tax credit when subject to tax under Subpart F. As currently constituted, the credit is available to a U.S. taxpayer with respect to foreign income taxes paid or accrued by a first-tier foreign corporation, in which it (the taxpayer) owns at least a 10 percent voting interest, and a second-tier foreign corporation, in which the qualifying first-tier foreign corporation owns at least a 50 percent voting interest. These rules are identical to the pre-1971 Section 902 rules.

Section 902, as amended in January 1971, allows foreign tax credit with respect to foreign income taxes paid or accrued by the following:

1. First-tier foreign corporation in which the taxpayer owns at least a 10 percent voting interest,
2. Second-tier foreign corporation in which a qualifying first-tier foreign corporation owns at least a 10 percent voting interest, and
3. Third-tier foreign corporation in which a qualifying second-tier foreign corporation owns at least a 10 percent voting interest,

provided that the taxpayer has at least a 5 percent indirect voting interest in the second- and third-tier corporations.

There is no apparent reason why the parallel formerly existing between Sections 902 and 960 should have been destroyed. Congressional intent in enacting Section 960 appears to have been to structure this section exactly like Section 902. Failure to amend Section 960 was apparently a legislative oversight in drafting the 1971 amendment to Section 902.

It is therefore recommended that Section 960 be amended to lower the percentage voting interest requirement to 10 percent in the case of second-tier foreign corporations and to encompass third-tier foreign corporations owned at least 10 percent by qualifying second-tier foreign corporations.

SECTION 1503

Carryover and Carryback of Foreign Tax Credit of Western Hemisphere Trade Corporation

The Code should permit carryover and carryback of foreign tax credit attributable to differential in normal U.S. tax rate and Western Hemisphere Trade Corporation rate. [Section 1503(b)(1)]

A Western Hemisphere Trade Corporation which is includible in a consolidated U.S. tax return has a restriction on its ability to use the excess of the foreign taxes it incurs over the effective 34 percent rate of tax which it pays to the U.S. against tax on other foreign income in a consolidated tax return. This effectively prevents the foreign tax itself from being utilized by the consolidated group in any way. We recommend that the statute be changed to permit the amount of foreign taxes between the 34 and 48 percent rates to be carried back and carried over against tax assessed on Western Hemisphere Trade Corporation income under the normal carryback and carryover provisions of Section 904(d).

Gain or Loss on Disposition of Property

SECTION 1014

Basis of Property Acquired From a Decedent

Section 1014(b)(6) should be amended to provide that the 100 percent fair market value rule applies, regardless of whether the property is held as community property, in joint tenancy, or as tenants in common.

Under Section 1014(b)(6) a surviving spouse's one-half share of community property takes on a basis equal to its fair market value at the applicable valuation date of the decedent spouse's estate. This new basis is applicable only if the decedent and the surviving spouse held the property as community property. As to property acquired with community funds to which the decedent and the surviving spouse took title as joint tenants or tenants in common, there is no new basis as to the surviving spouse's one-half. Thus, taxpayers in community property states are being treated in a manner inconsistent with non-community-property state taxpayers. In addition, in order to avail themselves of a consistent treatment (by continuing to hold community property as community property), taxpayers in community property states are foreclosed from obtaining the benefits (ease of passage of title, avoidance of probate costs, etc.) that would otherwise be available if they would take title to their community property as either joint tenants, etc.

Enactment of the foregoing recommendation would correct this unfair treatment.

SECTION 1032

Gain on Lapse of Warrants on Corporation's Own Stock

Amounts received by a corporation for warrants and options on that corporation's own stock should be treated in the same fashion as the proceeds of the sale of such stock whether or not the options or warrants are ultimately exercised and stock issued. [Section 1032(a)]

Regulations Section 1.1234-1(b) and Revenue Ruling 72-198 (1972-1 CB 223) hold that ordinary income results upon the expiration of warrants on a corporation's own stock. There seems to be no reason why the character of the gain or loss in such a situation should not be determined relative to the gain or loss that would be recognized on the underlying property.

Since the sale of the stock itself would not result in income, neither should the sale of the warrants or options. The present IRS interpretation puts a premium on form at the expense of substance. For example, corporation X sells its common stock for $10 a share and three years later buys the stock back for $8 a share as the result of a decline in the market value of the stock. Under Section 1032, no gain is recognized to corporation X. Corporation Y sells options on its stock, allowing the holder thereof to buy the stock at $10 per share, and receives $2 for each optioned share. Three years later, the stock having declined to $8, the warrants expire unexercised. Corporation Y would be deemed to have realized $2 per share of gain for tax purposes, even though for financial accounting purposes the $2 would be treated as part of capital surplus in the same fashion as the $2 realized by corporation X.

SECTION 1032

Exchange of Parent Corporation's Stock for Property

The nonrecognition of gain or loss provided under Section 1032(a) where a corporation exchanges its stock for property should also apply where a subsidiary acquires property in exchange for stock of its parent transferred to it for the purpose of making such exchange.

Where a corporation acquires property in exchange for its stock, no gain or loss is recognized to the corporation by virtue of Section 1032(a), and the basis of the property acquired is its cost, i.e., the value of the stock given. If the property is then transferred to a controlled subsidiary as a capital contribution or in exchange for stock of the subsidiary, the exchange would result in no gain or loss to the parent or to the subsidiary (see Sections 351, 118, and 1032(a)), and the parent's basis for the property would pass to the subsidiary under Section 362(a).

If, however, the parent transfers its stock to the subsidiary, and the subsidiary directly acquires the property in a transaction in exchange for such stock of the parent, there may be adverse tax consequences, although the substance of the transaction is the same as in the case where the parent acquires the property and transfers it to the subsidiary. The tax uncertainty is whether the parent's stock has any basis in the hands of the subsidiary. If there is no basis, the subsidiary would have a taxable gain equal to the value of such stock upon the exchange of the stock for property. This difference in tax treatment should not exist, particularly where the parent's stock is transferred to the subsidiary for the purpose of making the acquisition.

To eliminate this inconsistent treatment, it is recommended that Section 1032(a) be amended to make its provisions applicable where a subsidiary exchanges its parent's stock for property, provided such stock was transferred to the subsidiary expressly for the purpose of such exchange. A subsidiary would qualify for this treatment only if it were controlled by the parent within the meaning of Section 368(c). This would also make Section 1032 consistent with the "A," "B," and "C" reorganization provisions which permit use of the parent's stock by a subsidiary in a tax-free reorganization.

SECTION 1034

Sale or Exchange of Residence

A replacement residence should qualify if acquired during the period ending two years after the close of the year in which the residence was sold, and extensions of time, as under Section 1033, should be granted for good cause shown; the special provision relating to members of the Armed Forces should be eliminated, since these and other similar situations could be handled administratively under the extension authority.

Under Section 1034, a replacement residence must be purchased within eighteen months of the date of sale (or construction on a new residence have commenced within eighteen months, and the new residence occupied within two years). In our mobile society, and especially during repeated periods of economic upheaval, there seems no overwhelming reason for such a short time span and such a lack of flexibility.

It is recommended that the basic approach of Section 1033, which deals with involuntary conversions, also be applied to residences, and that, as in Section 1033, the taxpayer not only be allowed until the end of the second year following the year in which the sale takes place, but that the taxpayer also be able to get an extension of time from the IRS for good cause shown. There would then be no necessity to set up special rules to deal with special situations, such as the status of members of the Armed Forces, for such situations could be handled administratively.

Capital Gains and Losses

SECTION 1201

Capital Gains of Corporations: Alternative Tax

When net long-term capital gains exceed taxable income, the alternative tax rate should be applied to taxable income. [Section 1201(a)]

The tax liability of a corporation having an excess of ordinary deductions over ordinary income (an ordinary loss), and a net long-term capital gain in excess of such ordinary loss, is based upon the lesser of

1. Tax computed by applying the normal tax and surtax to taxable income (net long-term capital gain reduced by ordinary loss) or
2. The alternative tax of 30 percent on the amount of gain.

Irrespective of which calculation provides the lower tax, the ordinary loss is absorbed by the net long-term capital gain. In some instances, the taxpayer receives no benefit from the ordinary loss.

For example, a corporation has taxable income of $100,000, made up of net long-term capital gain of $125,000 and an operating loss of $25,000. Its tax is $37,500 (the lesser of the alternative tax rate of 30 percent applied to the entire net long-term gain or the normal tax and surtax of $41,500 on taxable income). If the corporation had realized only the net long-term gain, its tax still would be $37,500. Clearly, no benefit was received from the $25,000 operating loss.

The 30 percent maximum alternative tax should be applied to taxable income if such income is less than the net long-term capital gain. In the foregoing example, this treatment would result in an alternative tax of $30,000.

SECTION 1211

Treatment of Capital Losses

The $1,000 limitation on deductibility of net capital losses against ordinary income should be eliminated. Also, individual taxpayers should be allowed to carry back capital losses. [Sections 1211(b), 1212(b)]

Tax Policy Statement No. 1, "Taxation of Capital Gains," issued by the AICPA Federal Tax Division in 1974, contains the following recommendations:

- Narrow the statutory definition of capital assets.
- Extend the holding period requirement from more than six months to more than twelve months.

- Provide a sliding scale of exclusions for longer holding periods.
- Extend the concept of recapture of expenditures charged against ordinary income.
- Extend the capital loss carryback provisions to individual taxpayers.
- Eliminate (or in the alternative increase) the $1,000 limitation on deductibility of net capital losses against ordinary income.
- Continue the present policy of not imposing capital gains tax on unrealized appreciation of assets at death.

These positions should be adopted because of the present high rates of tax, particularly on individuals, our economy's great need for new investment capital, the increasing impact of inflation, and the tax burdens that may result from the 'bunching" of income when substantial sales of assets occur.

SECTION 1244

Qualification as Section 1244 Stock

The requirement that Section 1244 only applies if a plan exists should be eliminated. [Sections 1244(a), 1244(c)]

Section 1244 was added to the Internal Revenue Code of 1954 by the Small Business Tax Revision Act of 1958. The purpose of the Act as set forth in H. R. Rep. No. 1298, 85th Cong., 1st Sess., reprinted in 1959-2 CB 709, 711, was to aid and encourage small business. Admittedly, it was not an attempt to settle all of the tax problems of small businesses. Specifically, the House Committee on Ways and Means summarized the primary goal of the bill as follows:

> The bill is designed to increase the volume of outside funds which will be made available for the financing of small business. Encouragement of external financing is provided by the ordinary loss treatment accorded investments in small business which do not prove to be successful. In this manner the risk element in small-business investment will be decreased for all such investments, including the enterprises which ultimately succeed as well as those which fail.

During the period since the adoption of Section 1244, a number of cases have been litigated, most of which have denied ordinary loss treatment to shareholders of small business corporations. In these cases, the stock qualified as Section 1244 stock within the meaning of Section

1244(c), except that the corporate records did not document the existence of a plan at the time of issue.

The limitations of the benefits of Section 1244 to taxpayers who insert certain phraseology in corporate records places undue emphasis on form and is inconsistent with the objectives of the 1958 Act. Rather than encourage additional investment in small business, these continuing limitations serve to stifle investment and increase the risk factor.

Accordingly, Sections 1244(a) and (c) should be amended to broaden the scope of a qualified investment entitled to ordinary loss treatment and to eliminate the requirement that a plan be adopted. Loss on investments in small businesses in the form of stock or capital contributions held by a shareholder otherwise qualifying under the limitations of Section 1244(a) and meeting the definitional requirements of Section 1244(c)(1) (as amended) and Section 1244(c)(2) should be treated as Section 1244 property eligible for ordinary loss treatment.

SECTION 1250

Holding Period of Property With Transferred Basis

The holding period of Section 1250 property acquired in a transaction where all or part of the gain was not recognized, pursuant to Sections 1031 or 1033, should include the holding period of the previously held Section 1250 property to the extent additional depreciation on that property will be taken into account. [Section 1250(e)]

Under Section 1250(e), the provisions of Section 1223 which determine the holding period of property are not applied in determining the applicable percentage which shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in Section 1231. The holding period begins when the actual property involved was acquired or, in the case of property constructed by the taxpayer, placed in service. Special exceptions to this rule apply to numerous tax-free transactions including exchanges under Sections 332, 351, 721, 731, and 1034.

The holding period of property exchanged under Sections 1031 and 1033 is not added to the holding period of the property acquired in the exchange. As a result of this rule, for the purpose of determining treatment on the sale or exchange of the property acquired in such transactions, the taxpayer must apply a percentage determined with reference to the date of acquisition even though the additional depreciation with respect to the property exchanged is attributed to the property acquired pursuant to Section 1250(d)(4)(E).

The principle of the tacking rules of Section 1223 should be applied. The percentage based on the holding period should be computed on a segmented basis. The holding period prior to the Section 1031 or 1033 exchange should be ascertained for purposes of determining the percentage applicable to the additional depreciation computed at the time of the exchange. As to depreciation after the exchange, the holding period to determine the applicable percentage would commence with the date of acquisition.

Readjustment of Tax Between Years and Special Limitations

SECTION 1313

Meaning of "Determination"

The definition of "determination" for purposes of mitigation of the statute of limitations should be broadened to cover any situation where a taxpayer has paid a deficiency in tax and the statute of limitations has expired. [Section 1313(a)]

A "determination" now is limited in the case of deficiencies to court decisions, Section 7121 closing agreements, and special agreements "signed by the secretary or his delegate." In other situations, a "determination" can only take place as a result of a claim for refund. To prevent Sections 1311 through 1315 being a morass for the unwary even stickier than they otherwise will be, it should be provided that if a taxpayer has paid a deficiency in connection with the tax for any year, the "determination" as to such deficiency shall be deemed to take place when the statute of limitations on filing a claim for refund expires (unless a claim for refund is filed before the expiration of such time).

Election of Certain Small Business Corporations as to Taxable Status

SECTION 1371

Treatment of Corporate Joint Ventures

Joint ventures of corporate shareholders should be allowed under the Internal Revenue Code to "flow through" current profits or losses to the coventurers regardless of the legal organizational form used for the ventures.

It is fairly common practice for two or more nonrelated corporations to participate in a particular business venture of mutual interest to all participants. Under existing provisions of the Internal Revenue Code, it is possible to "flow through" current profits or losses to all participants only if a partnership or joint venture type of organization is used. This may be satisfactory in some cases, but the continued prevalent use of corporate form indicates that, in spite of the tax treatment, there are overriding reasons for use of corporations, particularly in foreign operations where doing business in an unincorporated form may not be feasible. Another widespread reason is the limited liability afforded through a corporate form of organization.

The Internal Revenue Code should be changed to permit the current profits or losses of the joint venture to be included in the gross income of the participants where the venture is conducted in corporate form. The availability of the "flow through" should be limited to corporate shareholders whose stock ownership in the "joint venture corporation" is at least 20 percent but less than 80 percent.

The change probably could best be accomplished by adding a new section to the Code (possibly Section 1380) rather than through the amendment of Section 1371.

SECTION 1375

Distributions of Previously Taxed Income

Section 1375 should be amended to prescribe that the distribution of property other than money should be recognized as the distribution of previously taxed income.

The Subchapter S election has proved to be substantially less useful than was originally intended because of complex and restrictive rules in the statute and in regulations issued by the Treasury Department. In particular, only a limited opportunity is granted for distribution of previously taxed income in later years. In this respect, the rules vary substantially from partnership treatment where withdrawal of earnings is not a taxable event.

This problem should be remedied by amending Section 1375 to provide that the distribution of property other than money should be permitted as a distribution of previously taxed income.

Estate and Gift Taxes

SECTION 2014

Credit for Foreign Death Taxes

The limitation on the amount of foreign death taxes creditable against federal estate tax should, at the option of the taxpayer, be determined on an overall basis. [Section 2014(b)]

Section 18 of the Revenue Act of 1962 amended prior law to eliminate the exclusion from the gross estate of real property situated outside the United States. This increase in the ambit of federal estate taxation focuses attention on the goal of avoiding double taxation of estates.

The amount of foreign death taxes creditable against federal estate tax is the lesser of two amounts under limitations computed on a per country basis. In 1960 Congress amended the foreign income tax credit provision in order to give taxpayers an election to compute that credit on either a per country basis or an overall basis. The same election should be available to fiduciaries of estates with assets in more than one foreign country.

SECTION 2504

Valuation of Gifts Made in Prior Years

The prohibition of an adjustment of the value of gifts made and exclusions allowable in prior years where the statute of limitations has expired should not depend upon the payment of gift tax. [Section 2504(c)]

Section 2504(c) now provides that the value of a gift made in a prior year cannot be readjusted in subsequent years if the gift tax was actually paid on the gift made in the prior year and the period of limitations for assessment has expired for such year. This requires that taxable gifts (gifts in excess of the allowable exclusions and deductions) must have been made in the prior year in order for the prohibition against the adjustment in value to be applicable.

It appears illogical not to permit the same prohibition to apply where no tax was payable because the allowable exclusions and deductions equalled or exceeded the value of the annual gifts made. It therefore is proposed that this section be amended to prohibit the adjustment of the value of gifts made in prior years as well as the amounts excluded, if any, with respect to such gifts, where the gift subject to valuation has been reported, whether or not a gift tax was paid, and the period of limitations for assessment has expired.

SECTION 2523

Gift to Spouse

The marital deduction should be determined annually.

The marital deduction should not be determined quarterly because the quarterly determination can produce varying amounts of marital deduction depending on the timing of the gifts during a year.

When Public Law 91-614 requiring quarterly filing of gift tax returns was enacted, the Senate Finance Committee stated that "the bill retains the structure of present law insofar as the determination of gift tax liability is concerned." Nevertheless it is clear that a change has taken place with respect to gifts to a spouse. Unless the reportable amount of gifts to a spouse exceeds $6,000 in the quarter in which the gift to a spouse first occurs, there may be a higher gift tax if the gifts for the year exceed $3,000.

As a result of the interplay between the annual $3,000 exclusion and the marital deduction, the amount of gift tax can vary depending on the timing of the gifts. In determining the amount subject to gift tax, the exclusion is deducted first, and then the marital deduction. Thus, if gifts to a spouse of $4,000 are made in each of two quarters of the same year, the annual $3,000 exclusion will be used up in the first quarter gift, and $1,000 will be allowed as a marital deduction. The marital deduction in the second quarter will be $2,000, and $2,000 will be subject to gift tax. However, had the entire $8,000 been given to the spouse in the first quarter, only $1,000 would be subject to gift tax because the annual exclusion would be $3,000 and the marital deduction would be $4,000.

The difference in result is not logical and apparently was not intended.

A modification should be made to allow the marital deduction to be deducted first. Before the quarterly filing requirement, it made no difference whether the marital deduction or the annual exclusion was deducted first. Because the annual exclusion has been retained even with the change to quarterly filings, the tax result should likewise be unchanged.

This proposed modification would not be necessary if gift tax returns were filed annually, as proposed in the recommendation for Section 6019.

SECTION 6019

Gift Tax Returns

Gift tax returns should be filed annually.

Gift tax filings on a quarterly basis have caused considerably greater administrative costs to the taxpayer and the government for the sake of speeding up the collection of gift taxes.

Currently, taxpayers must file gift tax returns within one-and-a-half months after the end of each quarter. Prior to the enactment of Public Law 91-614, annual returns were due on April 15 of the following year.

Many gift tax returns call for the payment of no tax or a very small tax. In such cases the extra paperwork does not speed up tax collections. The effect of the new quarterly gift tax return filing requirement is to make the payment of gift taxes more of a burden than the payment of income taxes.

We recommend that gift tax returns should be filed annually, but with an estimated gift tax return procedure where gifts in excess of $100,000 are made. The annual return filing date should be April 15.

Even if quarterly gift tax filings are continued, the due date for the gift tax return for the fourth quarter should be changed to April 15, because many gifts are made at the year end and the gift tax return filing is frequently handled by the taxpayer in conjunction with the filing of the annual income tax return at April 15.

SECTION 6166

Extension of Time for Payment of Estate Tax

An extension of time for the payment of estate tax where the estate consists largely of an interest in a closely held business should be permitted in more situations.

Section 6166(a) currently provides that deferment may be elected if the value of a closely held business that is included in determining the gross estate of a decedent exceeds either 35 percent of the value of the gross estate or 50 percent of the taxable estate.

However, the term "interest in a closely held business" as defined in Section 6166(c) limits the application to partners with 20 percent or more of the partnership capital, unless the partnership has no more than ten partners, and to stockholders with 20 percent or more of the value of the voting stock, unless such corporation has no more than ten shareholders. These limitations should be eliminated.

The 35 percent and 50 percent standards conform to the similar standards of Section 303 permitting redemption of stock to pay death taxes.

The present limitation to situations where there are ten or less partners or stockholders, or where there is a 20 percent voting stock equity or 20 percent partnership capital, is an unreasonable limitation. A deceased 5 percent partner in a ten-man partnership could qualify, but a deceased 15 percent partner in a fifty-man partnership would not qualify, even though the amount involved, the percentage of the estate, and the need for deferment of estate tax could be greater in the latter instance.

A similar inequity can occur in closely held corporations. It is not unusual for such a nonqualifying equity to constitute the bulk of a decedent's estate. Such interests are frequently not marketable, and the ten-year deferment of estate tax could permit an orderly realization of the moneys to pay the tax liabilities. Of course, the application of Section 6166 should be limited to instances where the decedent's stock is not readily marketable.

Employment Taxes

SECTION 3402

Income Tax Collected at Source

Section 3402(m) should be amended to allow an employee additional allowances for deductions and credits to be taken in arriving at adjusted gross income (as defined by Section 62).

Section 3402(m) allows an employee additional allowances for itemized deductions from adjusted gross income for the purpose of withholding taxes on wages.

Section 3402(i) allows an employee to have additional withholding deducted from his wages. Since an employer is obligated to withhold certain amounts or percentages of wages, the additional withholding is directed to cover income that would be subject to estimated payments (Sections 6015 and 6153). There is no reason why an employee should not also be able to have additional allowances to cover deductions taken in arriving at adjusted gross income and credits taken into account in determining net tax liability.

Each year the Treasury must make tax refunds, which are attributable to deductions taken in arriving at adjusted gross income or foreign tax credits on income derived and taxed abroad and which would not otherwise generate a tax refund but for the withholding of taxes on wages.

It is therefore recommended that Section 3402(m) of the Internal Revenue Code be amended to allow an employee additional allowances not only for itemized deductions but for those deductions allowed in arriving at adjusted gross income and certain credits. This change will not materially affect the revenue, but will reduce the amount of year-end tax refunds, and help reduce the technical complexity existing throughout our tax system.

Procedure and Administration

SECTION 6015

Installment Payments of Estimated Tax by Individuals and Corporations

Sections 6015(a) and 6154(a) should be amended to raise the minimum amount required for individuals and corporations to pay estimated income tax.

Section 6015 provides, in effect, that individuals are required to file a declaration of estimated tax and pay such tax if they reasonably expect the estimated tax to exceed $100.

Section 6154(a) provides that corporations that reasonably expect their estimated tax for the year to be $40 or more shall make payments of estimated tax.

The complexities of computation and the burden of payment requirements upon small businesses and individual taxpayers with limited resources, coupled with the expense of professional advice in order to understand and comply with these statutory requirements, necessitate the amendment of these sections of the Internal Revenue Code.

It is therefore recommended that estimated income tax payments for individuals be required only when it is reasonably expected that estimated tax will exceed $500 and that corporations be required to pay estimated income tax only when income tax payments are reasonably expected to exceed $1,000. These changes will not materially affect the revenue collections but will help reduce the paperwork, filing requirements, and technical complexity existing throughout our tax system.

SECTION 6405

Reports of Refunds and Credits

Sections 6405(a) and 6405(c) of the Code should be amended to increase the dollar limitation therein to at least $250,000.

Section 6405(a) and (c) provides, in effect, that reports must be submitted to the Joint Committee on Internal Revenue Taxation whenever tax refunds or credits exceed $100,000. Legislative history reveals that a $75,000 limitation was first imposed under the Revenue Act of 1928. It was raised to $200,000 in 1949 and reduced to $100,000 in the Internal Revenue Code of 1954. Committee reports are silent concerning the 1954 reduction of the limitation.

The preparation and review of Joint Committee reports are costly and time-consuming procedures. The requirement of these reports in the present framework of the IRS's activities as a necessity for equitable administration of the tax law should be reexamined. In view of present economic conditions, it is unrealistic to maintain a dollar limitation enacted in 1954. This dollar limitation should be raised to at least $250,000.

SECTION 6411

Tentative Carryback Adjustments—Foreign Tax Credits

Tentative carryback adjustments should be permitted for unused foreign tax credits in the same manner as now provided for operating losses, capital losses (in the case of corporations), and investment credit carrybacks.

Section 6411 now permits taxpayers with net operating losses, unused investment credit carrybacks, and corporate capital losses to file applications for tentative carryback adjustments (so-called "quick" claims) within 12 months of the close of the year in which the carryback arose. The amount of tax decrease resulting from the carryback must be refunded or credited within ninety days, subject to the right of the IRS to disallow the application in the case of material errors or omissions. The tentative allowance is subject to adjustment upon audit of the taxpayer's return. This provision originally applied only to net operating loss carrybacks and was extended to unused investment credit carrybacks in 1966 and net corporate capital losses in 1969.

The tentative adjustment procedure is designed to relieve taxpayers entitled to tax refunds from the economic burden of waiting until the audit of their tax returns is completed. Since examination of returns involving foreign income and tax credits is likely to be even more protracted than the usual audit, it appears logical that tentative adjustments of unused foreign tax credits also be permitted.

SECTION 6425

Quick Refunds (Forty-Five Days) as to Certain Corporate Quarterly Overpayments

Section 6425 should be amended to allow a corporate taxpayer to file, prior to the end of the taxable year, for a "quick refund" (forty-five days) as to certain overpayments of estimated installments.

Section 6425 provides that a corporation may, after the close of the taxable year and on or before the fifteenth day of the third month thereafter, and before the day on which it files a return for such taxable year, file an application for an adjustment of an overpayment of estimated income tax for such taxable year. Within a period of forty-five days from the date on which an application for an adjustment is filed, the IRS may credit the amount of the adjustment against any liability in respect of any tax on the part of the corporation and shall refund the remainder to the corporation provided the amount of the adjustment equals or exceeds (a) 10 percent of the amount estimated by the corporation on its application as its income tax liability for the taxable year and (b) $500.

Section 6425 was added in 1968 in order to try to avoid corporate overpayments as a result of the phase-out of the $100,000 exemption and the increase of the 70 percent test to 80 percent.

However, there is no present provision which would allow a corporate taxpayer to request a "quick refund" as to the overpayment of a specific estimated installment; the corporation must wait until the close of its taxable year. This does not permit the prompt refund of overpayments needed by a corporation faced by a sharp reduction of income from sudden business reversals.

Therefore, Section 6425 should be amended to allow a corporate taxpayer to file, prior to the end of the taxable year, for a "quick refund" (forty-five days) as to certain overpayments of estimated installments. The same 10 percent and $500 limitations applicable to past year-end applications (Form 4466) should apply to these refunds.

SECTION 6511

Statute of Limitations on Refunds Arising From Net Operating Loss Carrybacks

Claim for refund with respect to a net operating loss carryback should be timely if filed within three years from due date, including extensions, of the return for the loss year. [Section 6511(d)(2)]

If a taxpayer secures an extension for filing the tax return for a loss year, the statute of limitations on assessment will be extended to three years following the extended due date. Under Section 6511(d)(2), however, claim for refund based on carryback of the net operating loss must be made not later than three years following the original due date of the return for the loss year. Thus a gap is created during which assessment may be permitted but adjustments giving rise to additional refunds are barred.

This gap should be eliminated by providing that a refund claim based on a net operating loss carryback will be timely if filed not later than the expiration of the statute of limitations for assessment of tax with respect to the loss year.

SECTION 6601

Interest on an Underpayment on Form 7004

It should be made clear that, where a corporation has obtained an extension of time for filing its income tax return under Section 6081(b), interest will be charged on an underestimate only to the extent that the correct first installment exceeds the amount actually paid as a first installment.

A corporation is entitled to an automatic extension of time for filing its income tax return upon the filing of Form 7004 and the payment of one-half the estimated amount of its tax. Interest is quite properly charged where the corporation's estimate of its tax is less than the tax which is ultimately shown on its return. However, the amount of such interest is computed on a basis which is inequitable. The IRS takes the position that interest should be computed as if the Form 7004 were a final return. Thus, it computes interest on the excess of the final tax over that shown on Form 7004. The historical practice, before the enactment of Section 6081(b), was to charge interest only on the difference between the correct first installment and the amount paid as a first installment. This historical practice should be the present law.

The effect of the present practice is that an interest charge would be asserted under the following circumstances where no actual underpayment was involved:

Tax estimate per Form 7004	\$100,000
Installment paid with Form 7004	\$ 75,000
Tax per Form 1120 (final tax)	\$150,000

Under these circumstances, the Treasury's position is that interest should be computed for three months on \$25,000 (the difference between half the final tax and half the amount shown on the Form 7004).

SECTION 6653

Underpayment of Tax Due to Negligence

Where there is an underpayment of tax due to negligence, the 5 percent penalty should be imposed only on the tax effect of the negligently reported items. [Section 6653(a)]

Under Section 6653(a), a penalty of 5 percent of the total amount of any underpayment is imposed where any part of the underpayment is due to negligence or intentional disregard of rules and regulations (but without intent to defraud). It seems extremely harsh to impose a penalty on the total underpayment when other adjustments to taxable income unrelated to negligent reporting may have produced the greater portion of the underpayment. Therefore, it is proposed that Section 6653(a) be amended to impose the penalty on underpayment due to negligence only on that portion of the underpayment that is the result of the negligent reporting. The portion of the underpayment due to negligent reporting shall be the excess of (a) the tax computed after correctly reflecting the negligently reported items over (b) the tax computed without correctly reflecting the negligently reported items. All items unrelated to negligent reporting shall be correctly reflected in both (a) and (b) in the above computation.

SECTION 6672

100 Percent Penalty for Failure to Collect and Pay Over Tax

The enforcement of collection of a penalty under Section 6672 should be stayed during a period of judicial review and determination if the taxpayer posts a bond equal to 150 percent of the unpaid amount of the penalty sought to be assessed and collected.

The penalty imposed by Section 6672 applies only to the collection, accounting for, or payment over of all taxes imposed on a person other than the person who is required to collect, account for, and pay over such taxes. The Secretary of the Treasury or his delegate is given the right to assess and collect such taxes without judicial review. Judicial review cannot be had until at least a partial payment is made and suit instituted for recovery of the amount so paid.

Extreme hardships could result from the application of this section. It is possible that appreciated assets would have to be sold, resulting in the payment of income taxes on the profit, when a court might hold that there was no liability on the taxpayer for the penalty. Equity would demand that a person from whom amounts are sought to be collected under Section 6672 should have a right to post bond until such time as his liability is determined by judicial process. The posting of a bond of one and one-half times the amount of the tax would fully protect any loss of revenue which could be occasioned by delay in collection procedures.

SECTION 6901

Limitations on Assessment and Collection— Transferee and Fiduciaries

Section 6901(c) should be amended to provide that, where an eighteen-month prompt assessment period under Section 6501(d) has been granted, the additional one-year assessment period for transferee liability be added to that prompt assessment period and not to the general three-year assessment period of Section 6501(a).

Section 6501(a) states that the amount of any tax shall be assessed within three years after the tax return is filed.

Under Section 6501(d) in the case of any tax for which a return is required in the case of a decedent or by his estate during administration or by a corporation, the tax shall be assessed within eighteen months after proper written request therefor by the executor, administrator, or other fiduciary. Regulations Section 301.6501(d)-1 would indicate that the circumstances surrounding such a request would of necessity involve a transferee and/or a fiduciary.

Section 6901(c) provides that the period of limitations for assessment of any transferee liability will be one year after the expiration of the period of limitation for assessment against the transferor.

It is understood that the Code and regulations are applied by the IRS to the effect that the one-year additional period of assessment of transferee liability is added to the three-year assessment period under Section 6501(a) even in circumstances where an eighteen-month assessment period has been granted. This is an inequitable result. Section 6901(c) should be amended to provide that, in the case of an initial transferee, the period of limitation should be one year after the expiration of the period of limitation for assessment against the transferor under Section 6501(a) (three years) or Section 6501(d) (eighteen months) or Section 6501(e) (six-year period for substantial omission of items).

SECTION 7502

Timely Mailing

The postmarked date of mailing should be deemed to be the date of delivery or the date of payment. [Section 7502(e)]

Section 7502 should be amended so that all of its subsections conform to the general rule that the postmarked date of mailing shall be deemed to be the date of delivery or the date of payment. This is particularly important as to the exception contained in Section 7502(e), which imposes an undue hardship on the employer, requiring a more rigorous monitoring of due dates than the general statute seems to require.